Community Perspective: Is the NMTC Program Making a Difference in Low-Income Communities?

P. Jefferson Armistead
President, Community Development Solutions

The New Markets Tax Credit (NMTC) program, which aims to attract $15 billion of new investment to low-income communities over seven years, is generally considered to be the most important federal economic development subsidy for depressed areas in thirty years.[1] The program is not without its critics, however, and criticisms seem to center around four themes:

- These funds might be flowing to projects that do not really need them, such as projects that would have been built or businesses that would have received financing even without the subsidy provided by the credit.
- The program, which is targeted to low-income communities, defines low-income communities too broadly and so fails to concentrate investment in the neediest areas while also putting rural areas at a disadvantage.
- The program's tilt toward real estate limits its effectiveness as a tool for revitalizing low-income communities.
- Tax credits are being allocated and investment capital is flowing disproportionately to profit-motivated corporations at the expense of mission-driven organizations which better understand the needs of communities.

This article addresses each of these criticisms, highlighting the ways in which the NMTC program has responded to them and how the program has evolved over the last four years.

What Do We Know about the Program's Effectiveness?

The U.S. Department of the Treasury's Community Development Financial Institutions (CDFI) Fund has awarded tax credits that will generate $8 billion of investment to 170 Community Development Entities (CDEs) in three competitive rounds. More than two years after the first allocations were announced, there are finally some significant data that permit

[1] This statement was made to the author by a number of people interviewed for this and an earlier article, for example, by Robert Rapoza, President and Principal of Rapoza Associates and Manager of the New Markets Tax Credit Coalition, in an interview on October 14, 2004.

an initial analysis of what is actually happening as a result of the NMTC.[2] Because there is some lag time in reporting the transactions to the Fund, and because the great majority of the reported transactions were recent, the CDFI Fund has not yet had the opportunity to analyze them. It has therefore not yet been possible to use hard data about the characteristics of actual transactions to respond to the criticisms or to draw definitive conclusions about the program's effect on low-income communities.

Despite incomplete data, a significant amount of information about the program's effectiveness has been assembled in case studies, reports, and articles in the popular press. Case studies on a number of projects financed by the NMTC are described in *New Markets Tax Credits: Issues and Opportunities* published by the Pratt Center (Armistead 2005) and *New Markets Tax Credits: A Progress Report* published by the New Markets Tax Credit Coalition (New Markets Tax Credit Coalition 2005). CDEs such as the National Trust for Historic Preservation have released portfolio descriptions and reports. In addition, industry conferences sponsored by Novogradac and Company, the Reznick Group and others have proven to be a rich source of information about the implementation of the NMTC program. Finally, information available from the CDFI Fund, including an analysis of the way that the competitive process has changed over three application rounds, has allowed some insight into the program's implementation.

This article builds on the information outlined above. In addition, the author conducted 26 interviews with participants in the NMTC program, surveying a variety of community development practitioners–intermediaries, investors, lenders, consultants, government bureaucrats, advocates, lawyers, accountants and others.[3] The interviews and case studies also provide important insights into how this program is working on the ground.

Are the Credits Being Used for Projects that Would Have Been Done Without It?

The NMTC is a shallow subsidy. According to former Treasury Department official Cliff Kellogg, it expands "the range of what's 'investable' by providing slightly more return when investors are balancing the risk-return tradeoff." Kellogg said that the program was designed to "overcome false perceptions of market risk. The NMTC should encourage investors to 'take a second look' when they might otherwise decline a viable deal."[4] The potential short-

[2] The CDFI Fund is the unit of the U.S. Department of the Treasury designated to administer the NMTC program, in conjunction with the Internal Revenue Service. A Community Development Entity (CDE) is an organization – a kind of community bank – that applies to the Fund for an allocation of tax credits. If awarded an allocation, tax credits flow to taxpayer entities such as banks that make equity investments in the CDE. To date, $8 billion in NMTC have been awarded by the CDFI Fund (the Fund) to 170 Community Development Entities in three competitive rounds, with awards announced in March 2003, May 2004 and May 2005. See CDFI Fund website, http://www.cdfifund.gov. [Linda G. Davenport, Deputy Director for Policy and Programs, CDFI Fund, U.S. Department of the Treasury, Remarks at National Housing and Rehabilitation Association's Conference on New Markets Tax Credit Program, August 10, 2005.]

[3] The author conducted most of the interviews for the publication cited above between October 2004 and March 2005 and some additional interviews for this article in August and September 2005.

[4] Cliff Kellogg's Keynote Address to Novogradac & Company LLP's New Markets Tax Credit Conference, June 7, 2002, http://www.novoco.com/NMTC/Resources/kellogg_keynote.doc.

coming of this shallow subsidy strategy is that, in theory, instead of making "undoable" or "marginal" deals possible, the credits could be used to "sweeten" deals that were feasible without it. Although skeptics are right to point out that this could happen with the NMTC in theory, the critical question is whether this is happening in practice. In other words, are there signs that the subsidy really is sweetening deals rather than making undoable deals doable? And if so, are program administrators taking steps to limit this outcome?

A wide variety of community development practitioners claim that the NMTC program is successful in its mission of bringing capital to communities where it was in short supply (see Armistead 2005). Interviewees with this view included individuals with a broad view of the community development industry, including: Bart Harvey, CEO of the Enterprise Foundation; Michael Rubinger, CEO of the Local Initiatives Support Corporation (LISC); Evelyn Kenvin, Director of Community Investments, Citigroup; and Frederick Copeman, National Director of Tax Credit Investment and Advisory Services, Ernst and Young.

When asked to discuss whether they thought the credit was being directed to projects that couldn't have been done in its absence, respondents overwhelmingly said they believed on the basis of their experience that it was. Mr. Copeman made the point that he was initially concerned about this issue, but had been pleased with the way it has worked out. He credited the CDFI Fund with doing a good job of allocating credit authority to CDEs that are financing what he called "but for" projects–ones that would not have been done without NMTC subsidy.[5] Several interviewees focused on the fact that they only consider investments that are made financially feasible with the addition of NMTC. Many said they would not finance a project that could be done with conventional unsubsidized financing.[6]

In part, this pressure to ensure that the NMTC provides "but for" financing is the work of the CDFI Fund, which implements the tax credit allocation process. The Fund has modified the application process and is attempting to give greater weight to applications that target more highly distressed communities with more than the statutorily required minimum amounts of subsidy. The Fund is relying on competition to induce applicants to promise more, using the allocation agreement to require performance consistent with the application, and linking subsequent allocations to the achievement of required milestones.

The goal of deeper targeting of the tax credits is reflected in successive rounds of the allocation applications. Consider the following changes in the NMTC application:[7]

- In the third allocation round, the CDFI Fund introduced a new question (# 36) to focus more attention on the issue of where the subsidy provided by the tax credit is going, asking applicants "how will the economic benefits of the NMTC allocation be

[5] Interview with Bart Harvey, October 26, 2004; interview with Michael Rubinger, October 25, 2004; interview with Evelyn Kenvin, August 9, 2004; e-mail correspondence with Frederick Copeman, March, 2005.

[6] They included the following: LISC's Robert Poznanski, President of the New Markets Support Corporation; James Walker, Managing Director of Enterprise Social Investment Corporation's ESIC Realty Partners; and John Leith-Tetrault, Director of the Community Partners Program of the National Trust for Historic Preservation.

[7] The NMTC application can be found on the CDFI Fund website: http://www.cdfifund.gov/docs/NMTC/2005/2006NMTCapplication.pdf.

apportioned amongst: the investors, through economic returns; the Qualified Low-Income Community Investment (QLICI) investees/borrowers, through lower costs of capital; and the applicant, through fees or economic returns?" In other words, who is getting the subsidy–investor, CDE, or community project?[8]

- In both rounds two and three, all allocatees indicated that at least 75 percent of Qualified Equity Investment (QEI) proceeds would be used to provide products with more favorable rates and terms than those available in the market. In round three, 88 percent of allocatees (36 of 41) indicated that 100 percent of their loans and investments would have flexible or nontraditional features.[9] In the 2006 application, a new question (# 19) asks if the applicant will "commit that all of its QLICI-related debt financing will have interest rates that are at least 25 percent lower than the prevailing market rates for the particular product . . . or for every QLICI, meet at least three of the criteria for flexible or non-traditional features."[10]
- In round two, 67 percent of allocatees (42 of the 63) indicated that they would invest at least 95 percent of NMTC proceeds into low-income communities, rather than the required 85 percent. In round three, 85 percent (35 of the 41) said they would invest 95 percent; and 22 percent (9 organizations) indicated they will invest 100 percent in low-income communities.

These increasingly higher thresholds and benchmarks give some indication of the Fund's intention to use its administrative powers to maximize the extent to which the subsidy goes to the deal. Creating a competitive process that encourages applicants to "bid" these objectives in their application is a good first step. However, a strong compliance system is necessary in order to tie outcomes to bids. The Fund has created and begun implementation of a Community Investment Impact System (CIIS) with this capability.

CIIS is designed to allow the Fund to measure the impact of CDE investments on low-income communities using a variety of metrics to compare CDEs' performance with their benchmarks in the allocation agreements, and to use the results to inform future allocation decisions. The Fund intends to use the data to further refine the fourth round competition ($3.5 billion of allocations), but it remains to be seen whether they will be able to do this given recent budget and staff cuts.

Is the Targeting Too Broad and Does it Give Short Shrift to Rural Areas?

Targeting Economically Distressed Areas. To be eligible for NMTC, an investment must be located in a census tract that has at least 20 percent poverty or where the median family

[8] 2005 NMTC Allocation Application, p. 20. http://www.cdfifund.gov/docs/nmtc/2005/2005NMTCapplication.pdf.

[9] The Fund did not report the corresponding number for round two.

[10] According to the application, flexible or nontraditional features include: "Equity Investments, Equity Equivalent terms and conditions, Debt with equity features (e.g., debt with royalties; debt with warrants; convertible debt), Subordinated debt, Below market interest rates, Lower than standard origination fees, Longer than standard period of interest-only loan payments, Higher than standard loan to value ratio, Longer than standard amortization period, More flexible borrower credit standards, Non-traditional forms of collateral, Lower than standard debt service coverage ratio, Loan loss reserve requirements that are less than standard." (NMTC program 2006 Application, p. 10.)

income does not exceed 80 percent of statewide median family income or the metropolitan area median family income. Nearly 39 percent of the census tracts in the country are eligible for the NMTC program (GAO 2004, p. 4). This broad targeting, rather than a focus on geographies with higher distress indicators, has been a source of some criticism. In practice, however, this has been offset to a certain extent by factors in the competitive application process which allow applicants to score additional points for committing to make investments in areas of greater economic distress. It appears that incentives such as these in the competitive allocation process are having some effect. In round two, 70 percent of allocatees (44 out of 63) indicated that at least 70 percent of their investment dollars would be made in communities of higher economic distress. In round three, 90 percent (37 out of 41) made this statement. Nearly half (20) indicated that 100 percent of their activities will be provided in such areas. In addition, in the 2006 application, the Fund asks applicants to commit to providing at least 75 percent of their QLICIs in areas that meet an even higher standard of economic distress than in prior years.[11]

Allocations to Rural Areas. On average, only about 17 percent of allocations in the first three rounds–about $1.35 billion out of $8 billion–have been to CDCs whose target communities are rural areas. This has been a disappointment to rural community development practitioners and their supporters. These groups have been frustrated that they have received fewer tax credits (17 percent) relative to their share of the population (21 percent). Concern over this disparity, particularly over the drop from a 20 percent allocation to rural areas in the first round to 15 percent in the second, led the New Markets Tax Credit Coalition and others to advocate for a legislative change, passed in October 2004, which expanded the definition of low-income community applicable to rural areas. Advocates for rural community development are seeking additional legislative changes as they campaign to reauthorize the NMTC program.

Is this a major flaw? It might be, but it is too early to draw conclusions. The concern that has been raised is about the allocation of credits to CDEs serving rural areas, but it may be the case that there are fewer NMTC-eligible investments in QALICBs in rural areas. This is an area where we need more information. For example, we do not yet know how the $1.35 billion allocated to date for rural areas compares to the effective demand for QLICIs in those areas. There just may not be enough potential investments.

Another potential NMTC financing problem for rural projects is that they may be too small. As discussed in the next section, one characteristic of the NMTC program is that high transaction costs make it difficult for CDEs to make loans/investments in projects smaller than about $3 million. If rural deals that seek tax credit financing turn out in general to be significantly smaller, it will be difficult to craft a solution for rural areas.

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[11] NMTC program 2006 Application, Question 29, p. 17.

Does the Tilt toward Real Estate Limit the Program's Effectiveness as a Tool for Revitalizing Low-Income Communities?

The NMTC program favors real estate investments. CDFI Fund data report that the likely use of funds from the second and third rounds combined is $3.1 billion (56 percent) for real estate projects and $1.8 billion (33 percent) for businesses. The remaining 11 percent is for capitalization of other CDEs (Rapoza 2005). The percentage likely to be invested in real estate grew to 61 percent in the third round from 54 percent in round two. This outcome is driven in part by the program's penalties for investments that move out of qualified census tracts or cease to serve a public purpose. These penalties are known as "recapture" by the IRS. This outcome is particularly disappointing to the community development venture capital sector and to others working to facilitate investments in businesses in low-income areas.

Those who wanted to see NMTC investment in businesses and entrepreneurs were encouraged by the Clinton administration's New Markets Tours of 1999 and 2000. The President, along with business leaders, toured a number of high-profile poor communities and the language of the speeches and media coverage focused on making capital available to businesses in poor communities. That led supporters of business lending and investing to have high hopes that the NMTC would be a tool for them. The New Markets Initiatives advocated by the President also included other features which might have been more effective in facilitating business lending and investing, such as the American Private Investment Companies. Those features were not included when the New Markets Tax Credit was passed in December 2000.

Despite some disappointments, it is hard to draw the conclusion that the NMTC program has not turned out to be what its designers intended. The program appears to work well for real estate projects, generating an important economic boost in targeted communities. At the same time, however, the NMTC Coalition is currently working with its community development venture capital and business lending members to decide what legislative changes to pursue that would promote business investment. No decisions have yet been made on a lobbying strategy, according to Alison Feighan, vice president and partner at Rapoza Associates.[12]

Are Tax Credits Being Allocated Disproportionately to For-Profit CDEs at the Expense of Mission-Driven Organizations?

Kevin Kelly, Grants Management Director for the National Congress for Community Economic Development, Robert Brandwein, president of Policy and Management Associates, Inc., a community economic development consulting firm, and many others have asked if mission-driven organizations are getting their fair share of funds under the NMTC program.[13] To fairly evaluate this concern, we need to distinguish between the distribution

[12] Interview with Alison Feighan, Vice President and Partner, Rapoza Associates, August 29, 2005. Rapoza Associates is the manager of the New Markets Tax Credit Coalition.

[13] Interview with Kevin Kelly, Grants Manager Director, National Congress for Community Economic Development, August 30, 2005. Interview with Robert Brandwein, Policy and Management Associates, August 30, 2005.

of allocations among different types of CDEs, and the distribution of investments by CDEs among different types of QALICBs. We also need to understand the standard against which the share going to community-based development organizations is measured.

CDEs can be classified into three groups:

- ***for-profit*** – those with profit-driven parents, like banks and investment banks;
- ***mission-driven*** – those with mission-driven parents like nonprofit CDCs and intermediaries, CDFIs and related organizations; and
- ***public*** – those with governmental parents such as housing finance agencies or public economic development agencies.

Over the course of three rounds, about 47 percent of the funds have gone to for-profit CDEs, about 41 percent to mission-driven CDEs, and about 12 percent to public CDEs. The share to for-profit CDEs has been as low as 44 percent in the first round and as high as 51 percent in the second round. The share to nonprofit CDEs has been as low as 36 percent in the second round and as high as 44 percent in the third round. The share to public CDEs has ranged from eight percent to 16 percent.

Does the disparity between the shares going to for-profit CDEs (47 percent) and mission-driven CDEs (41 percent) matter? Does it presage a negative outcome for low-income communities? It is not immediately apparent that there is a problem here. First, it is important to note that the disparity is small. Second, the important question for advocates of community-based development is not who gets the allocation, but whether or not their constituents' projects receive capital investment. We do not know how much of a correlation, if any, there is between the for-profit/mission-driven nature of the CDE and the for-profit/nonprofit ownership of the project receiving the investment. Examples of various different combinations abound–for-profit CDEs investing in nonprofit QALICBs, nonprofit CDEs investing in for-profit QALICBs, etc. Third, there also may not be a problem in the long run because some nonprofit developers such as CDCs seem to have taken steps to partner with a for-profit CDE at the time that the CDE applies for an allocation, providing the CDE with more community support in the application process and reserving a place in the pipeline for the CDC.

If it turns out that projects of nonprofit CDCs are having difficulty in getting NMTC financing, it may be a problem of size. Staff at a number of CDEs suggested that because of high transaction costs, the minimum loan or investment they could reasonably make is in the range of $3 million to $5 million. This would exclude many CDC deals.

Community development practitioners are working to find ways around this small-investment problem. James Walker, managing director of ESIC Realty Partners' (ERP's) CDE, notes that ERP is supplying the Enterprise Foundation's lending arm with financing subsidized by the NMTC, which they are lending in amounts as small as $100,000. Robert Poznanski, President of LISC's New Markets Support Corporation, says that LISC is also working on the problem of originating smaller loans subsidized by the NMTC and expects to be rolling out a program soon. According to Mary Tingerthal, Chief Credit Officer of the Community Reinvestment Fund, her organization is approaching this problem by creating a secondary market for community development loans, including business loans, averaging about $300,000.

Strategies like the ones mentioned above are important because the nature of the NMTC program seems to be driving a trend toward larger allocations from the CDFI Fund. The median allocation has steadily increased from $21 million to $47 million to $50 million over the last three rounds. The smallest allocation increased from $500,000 to $5 million. Allocatees, applicants and the Fund have learned that operating a CDE is a complex, expensive operation with high transaction costs, and the inefficiency of operating with a very small allocation has become apparent. Although it may be overstated, one interviewee said it does not make sense to try to operate a CDE unless you expected to obtain and use an allocation of $100 million a year.

Conclusion

The NMTC, passed into law nearly five years ago, has shown significant promise in achieving its objective of attracting at least $15 billion of new capital into targeted communities where investment capital has been scarce. It appears that the subsidy is being used to make marginal projects doable, putting them over the top in terms of their ability to obtain financing. Although a broad definition is used to designate eligible low-income communities, competitive pressures for allocations appear to be working to target the funds more narrowly to areas of greater economic distress. Program structure, particularly with regard to recapture provisions, is causing a significant tilt towards real estate projects, which has been disappointing to proponents of increased business investment, but which is nonetheless consistent with the objectives of the program's design. Finally, the distribution of allocations among for-profit, mission-driven and public CDEs does not appear to be causing undesirable outcomes with respect to the availability of capital to different types of low-income community businesses. It does appear that the difficulty of using the NMTC to make small loans and investments will be an enduring one.

In light of these positive results to date, supporters of community economic development are in a strong position to advocate for a reauthorization of the NMTC, which is proving to be a powerful and effective tool for the economic development of distressed communities.

Jeff Armistead, President of Community Development Solutions, provides consulting services on a broad range of issues to CDCs, CDFIs, financial intermediaries, NMTC CDEs, and foundations. He is also a Senior Fellow at the Pratt Center for Community Development in Brooklyn, New York. Mr. Armistead's career includes positions at the Local Initiatives Support Corporation, the New York City Department of Housing Preservation and Development, and Neighborhood Housing Services of New York City. He is particularly interested in community economic development issues.

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