ECONOMIC INNOVATION GROUP

Unlocking Private Capital to Facilitate Economic Growth in Distressed Areas

BY JARED BERNSTEIN, CENTER ON BUDGET AND POLICY PRIORITIES
AND KEVIN A. HASSETT, AMERICAN ENTERPRISE INSTITUTE

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In recent months, there has been significant renewed attention from a broad spectrum of policymakers in addressing the impact of the uneven economic recovery through geographically focused economic policies designed to counteract poverty with special incentives to private investors.

Such polices in the United States date back to the 1970s and 1980s, when a number received rare bipartisan support and were enacted, with varying degrees of success. In the aftermath of the Great Recession, long-term unemployment, slow growth, and a lack of quality employment opportunities remain an acute problem, and are especially intense in many specific locales around the U.S. In this paper, we discuss tax preferences that have been used in the past to motivate investors to invest in disadvantaged regions of the United States, summarize the evidence exploring the effectiveness of these measures, and then discuss the shortcomings of previous policy designs. We finish with a sketch of a new type of structure that could be far more effective in stimulating economic growth and facilitating the creation of new jobs in areas of the country struggling the most.

I. The Uneven Economic Recovery and Problem Of Geographic Disparities

More than five years after the end of the Great Recession, the U.S. is on the path of slow but steady economic recovery. The unemployment rate fell to 5.5 percent in February 2015, but a significant number of potential workers have not re-entered the labor force since the end of the recession and wage growth remains tepid.[1] Last year, the economy finally added more jobs than were lost during the recession, but a closer look at the nature of those new jobs reveals that a large share of mid- to high-paying jobs were replaced by lower-wage positions. At the same time, the stock market has reached all-time highs, and foreclosure rates have come down.

However, while certain areas of the country are doing remarkably well and nearing or exceeding their pre-recession economic states, the recovery has been profoundly uneven, with large swaths of the country facing chronic rates of long-term unemployment and historically low levels of new investment. Nationally, we see historically low numbers of new business ventures being established. In addition to the unevenness of the recovery geographically, the unevenness within different income groups has been a growing concern for many policymakers.

While much of the popular policy conversation focuses on income disparities among individuals, geographic disparities are an equally important part of American life. As of December 2014, for example, the unemployment rate in Fresno, California was 11 percent, while the unemployment rate in San Francisco—less than 200 miles away—was five percent. Multiple other cities in California are currently experiencing elevated levels of unemployment: El Centro, California had an unemployment rate of 23.1 percent in December 2014, while Merced and Yuba City were at 12.6 and 12.2 percent, respectively. Modesto, California hit 10.5 percent.

Snapshot variations are common, but differences can last a number of years as well. Yuma, Arizona has had a consistently high unemployment rate—the last time it was below 20 percent was March 2009, and was at an incredibly high 25.6 percent in December 2014.

Extremely high unemployment in cities such as Fresno, Yuma, or Detroit leads to pockets of distressed and traumatized workers who face plummeting incomes, stalling career progressions, and cracking self-confidence. In addition to these intuitive tragic effects of unemployment, research has also identified other negative side effects, the most distressing of which is an increase in mortality following job loss. Studies have linked job losses to increases in death rates ,[2] suicide rates ,[3] and even serious illnesses such as cancer .[4] Another recent study on neighborhood effects found that growing up in the poorest quartile of neighborhoods versus the top quartile leads to a lifetime earnings gap as significant as between a high school and a college graduate.[5] More subtle effects have also been identified; some studies suggest that unemployment leads to a higher

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likelihood of divorce[6] and lower achievement outcomes for children of unemployed workers.[7] Worst of all, the longer the unemployment spell, the less likely the possibility of reemployment[8]—and by extension the opportunity to escape these terrible costs—becomes.

Not only have some regions been vastly more successful at generating jobs than others, but significant regional variation in the quality of employment growth exists as well. For example, an analysis by *The Atlantic*[9] found that Las Vegas, Sacramento, Philadelphia, Buffalo, and Hartford were among those that lost the most high-wage jobs, while job growth since the recession in areas like St. Louis, Riverside, New Orleans, Rochester, New York, Tampa, Columbus, Orlando, and Birmingham was mostly tied to low-wage jobs. Many workers are underemployed, working part-time but looking for a full-time job, a problem that may be worse in distressed communities.

The social costs of living in a high-unemployment area are also compelling. New generations born into these areas have fewer opportunities due to a lack of public investment and jobs. Older generations have the strong social ties to families, friends, and culture that prevent them from moving away, so instead they remain in areas with stalled or declining fortunes. Distressed communities, in essence, face very high transition costs. All the while, better-off cities receive a federal subsidy from the tax exclusion of state and local taxes from federal taxation.

The difficulty with which unemployed workers relocate—often staying in place due to social factors even when geographical wage differentials exist—creates a vicious cycle of persistently high unemployment in the same places. Distressed communities can be thought of as caught in a bad equilibrium outcome, where some economic shift has left the city with declining private activity and a falling tax base. This leads to a drop off of public investment and infrastructure, making it even more difficult to attract private capital. In essence, capital liquidity constraints both drive and are driven by a lack of public infrastructure, resulting in an equilibrium characterized by decay.

The proliferation of severely distressed areas around the country has been a drag on the overall health of the U.S. economy and the pace of the economic recovery. Where GDP growth falters in one area, it has an impact on the U.S. as whole not only by acting as a drag on overall production but also because distressed areas are potential markets for consumption of goods produced elsewhere in the U.S. and their weakness has a spillover effect on other communities. High levels of unemployment in one area contribute to nationally high levels of unemployment, along with larger national expenditures on unemployment insurance and other welfare benefits to those who are out of work. The implications of distressed communities for the United States as a whole further establishes the case for new policy prescriptions to combat the weakness of distressed areas.

II. Addressing Geographic Economic Disparities

A federal subsidy for private activity can knock the community out of the bad equilibrium and help it back on its feet. In response to the view that circumstances have at times specifically disadvantaged some geographic areas, a number of programs have been introduced over the years that were designed to address geographic disparities and provide extra incentives for investors to focus their efforts where the need is perceived to be the greatest.

There are solid economic arguments for providing these subsidies. First, it is a strong empirical regularity that, while economic theory might predict that individuals should move away from a city or neighborhood in a downward economic spiral, many chose not to. Thus, the existing social safety net will provide benefits to such individuals, benefits that will be quite costly to governments at all levels. Given the high costs of these benefits, it seems possible that a prudent reform could be a net positive for the budget. Second, once a downward spiral has begun, an opportune objective of policymakers would be to create a new equilibrium where investors decide to return to a distressed area because they expect other investors to return as well. Incentives that are attractive enough could plausibly upend the "Nash equilibrium" where investors choose not to invest because all of the other investors have made that choice as well.

Most of the primary federal measures introduced in the past to address these geographic disparities have expired as of the end of 2014. As many regions are still struggling with high unemployment, policymakers are now actively considering the reinstatement of legacy geographic-based policies and the design of new alternatives in the near future.

Four main types of federal programs for distressed communities with special tax incentives have existed in the U.S.: empowerment zones (EZ), renewal communities (RC), enterprise communities (EC), and the New Market Tax Credit (NMTC). The goals of these programs—first created in 1993 in the case of EZs and ECs, with the addition of RCs and the NMTC in 2000—have been to alleviate poverty, reduce unemployment, and boost economic activity in targeted areas. While the enterprise community and renewal community programs have expired, the tax provisions for empowerment zones and the NMTC were extended through the end of 2014 and are currently awaiting renewal by Congress—along with dozens of other temporary tax provisions.

Empowerment Zones, Renewal Communities, and Enterprise Communities

Designation of an area as an EZ, RC, or EC has generally followed after a nomination from the Secretary of Housing and Urban Development or the Secretary of Agriculture based on defined characteristics such as population size, poverty rate, unemployment rate, etc .[10] Businesses in areas that became a part of the program qualified for a number of credits and tax benefits to incentivize location within the zone or hiring individuals who live and work within a zone. For instance, if a business sold a qualified EZ asset it held for more than a year, it could elect to postpone part or all of the gain from sale if it purchased other qualified EZ assets within 60 days .[11] Another example is the EZ employment credit of up to $3,000 a year, which provided businesses with an incentive to hire individuals who live and work in an EZ. A business located in an empowerment zone could also increase its deduction under section 179, which allows it to deduct all or part of the cost of qualifying property the year it is placed in service, by up to $35,000.

A summary of all the previously available provisions is included on the following page.[12]

Unfortunately, research into the effects of these enterprise zone programs in the U.S. has found at best mixed results, with little consensus in the literature as to whether they are beneficial. Before instituting a national enterprise zone program in 1993, numerous state and local programs existed in the U.S. and were examined in an attempt to get an early idea of a national program's potential effectiveness. In 1988, the U.S. Government Accountability Office (GAO) conducted an analysis of an enterprise zone program in Maryland that resembled proposed federal legislation in order to report to Congress on its effectiveness. Although the GAO found that employment did increase in enterprise zones, they also extensively interviewed businesses, which reported that the program was not a significant reason why they increased employment or located their establishments within an enterprise zone.[13] It is an open question, of course, whether such survey evidence is meaningful.

Since that preliminary assessment, research into the effects of enterprise zone programs has found similarly mixed results, with some studies reporting positive effects on the local labor market in zones and others finding no discernible changes. Soon after the initial GAO report, Barry Rubin and Margaret Wilder (1989) analyzed state-level urban enterprise zones and found them to be a cost-effective tool to improve one area's comparative advantage against another in an urban setting.[14] Subsequent research by Leslie Papke (1994) found mixed effects of Indiana's state program; while unemployment claims in zone-designated areas fell by 19 percent, the value of depreciable personal property within the zones also fell by 13 percent.[15] Contradicting these findings, Marlon Boanet and William Bogart (1996) reported that in their analysis, New Jersey's urban

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Federal Tax Benefits Specifically Available To Businesses Operating In EZs, ECs, and RCs [16]

TAX BENEFIT	APPLICABLE ZONES	PROVISIONS
EZ Employment Credit	EZs	Businesses can claim a 20-percent credit on the first $15,000 paid in wages to EZ residents who perform substantially all of their work in the EZ.
Increased Section 179 Deduction	EZs and RCs	Qualified businesses can deduct $35,000 more than the maximum allowable deduction under certain qualifying property in the year the property was placed in service.
Enterprise Zone Facility Bonds	EZs and Round I ECs	State and local governments can issue tax-exempt bonds to provide loans to qualified businesses to finance certain property. A business cannot receive more than $3 million in bond proceeds for activities in any EZ or Round I EC or more than $20 million for activities in all EZs and Round I ECs nationwide. These bonds were also subject to state volume caps, which limit the amount of tax-exempt debt that state and local government entities can issue.
EZ Facility Bonds	EZs	State and local governments can issue tax-exempt bonds to provide loans to qualified businesses to finance certain property. State and local government entities can issue up to $60 million for each rural EZ, $130 million for each urban EZ with a population of less than 100,000, and $230 million for each urban EZ with a population greater than or equal to 100,000. These bonds were not subject to state volume caps.
Non-recognition of Gains on the Sale of EZ Assets	EZs	Taxpayers that incur capital gains on the sale of qualified assets can elect to postpone those gains from tax liability if they purchase a replacement asset within 60 days.
Partial Exclusion of Gain on the Sale of EZ Stock	EZs	Taxpayers that hold stock for more than 5 years in corporations with assets under $50 million incur a tax liability on only 40 percent of their capital gains, provided the company offering the stock was a qualified zone business.
RC Employment Credit	RCs	Businesses could claim a 15-percent credit on the first $10,000 paid in wages to RC residents who performed substantially all of their work in the RC.
Commericial Revitalization Deduction	RCs	Businesses that received an allocation from an agency authorized by the state for costs associated with new construction or renovation of non-residential commercial property could either deduct half of the qualifying expense for the year in which a building was placed in service or amortize all of the expenses over a 10-year period.
Zero Percent Capital Gains Rate for RC Assets	RCs	Investments in qualified RC businesses purchased after 2001 and before 2010 and held for more than 5 years were not subject to tax liability on capital gains.

program in the 1980s did not have a significant impact on unemployment or property value in designated zones. [17]

Research into state enterprise zone programs in the first decade of this century also found little impact of the programs on local job markets. In an evaluation of multiple state enterprise zone programs, Daniele Bondino and John Engberg (2000) could find no significant impact on employment, with little difference between the effects of different types of programs or different amounts of money spent on them. [18] Similarly, Greenbaum and Engberg (2000) found no evidence that enterprise zone programs in the six states that they analyzed had an effect on unemployment; although they found an increase in new business activity within zones, existing businesses offset this by decreasing their own activity. [19] Analyses of California's enterprise zones have found conflicting results. While O'Keefe (2004) concluded that enterprise zones experienced greater increases in employment than similar areas that were not given the enterprise zone designation, [20] Neumark and Kolko (2010) found no effect of the program on employment, even among lower wage workers. [21] Elvery (2009) reached similar conclusions in an analysis of California and Florida's programs, reporting no evidence that they improved the probability of a worker residing within the zones finding employment. [22]

Though the U.S. federal government enacted its first enterprise zone program in the form of Empowerment Zones and Enterprise Communities in 1993, GAO analyses in both 2006 [23] and 2010 [24] failed to reach a conclusion about the effectiveness of the two programs due to poor data collection by the agencies responsible for administering the programs. While some of the EZs and ECs did experience reductions in poverty and unemployment, it was not possible in their analysis to tie this to the program. However, a recent study by Ham, et al. (2011) that analyzed federal enterprise zones alongside state programs found that federal programs may actually have a greater impact on labor markets than state programs. [25] Although they found positive impacts for both levels of programs, they estimated a higher impact of federal programs on unemployment and poverty rates within localities. Similarly, a study by Matias Busso, Jesse Gregory, and Patrick Kline (2013) reviewing the first round of EZs found that an EZ designation substantially increased employment in zone neighborhoods and generated wage increases for local workers without a corresponding increase in population or the cost of living. [26]

New Markets Tax Credit

Arguably the most successful of the federal legacy programs for stimulating investment in distressed areas is the New Markets Tax Credit (NMTC). The NMTC, which bears some resemblance to the general idea we propose below, provides individual and institutional investors with a 39 percent tax credit against their federal tax liability for the provision of loans, investments, and even financial counseling to distressed areas. The credit is incrementally claimed over a seven-year time period: five percent in each of the first three years and six percent for each of the following four years, making this a vehicle that tilts toward quite patient capital, since the investment must be held for seven years.

The NMTC investments are made through a Community Development Entity, a private entity that must qualify for the program based on the unemployment, poverty rates, and low-income levels of the census tract area that the CDE represents (75 percent of NMTC projects have been undertaken in communities with poverty rates above 30 percent). According to the Local Initiative Support Corporation (LISC), an intermediary for the program, since 2000, $31 billion has been invested in the program in small businesses, including small manufacturers, charter schools, health and child care centers, and shopping areas. [27] Interesting, and germane to our idea discussed next, LISC notes that according to a GAO study, almost 90 percent of NMTC investors say that but for the credit, they would not have made the investment.

A 2013 Urban Institute evaluation of early-year NMTC projects came to a more nuanced conclusion, finding that 64 percent of the projects would not have happened at the same time and in the same location without the NMTC, but in only half of those cases did investors claim that the NMTC was the deciding factor in whether to make the investment at all.[28] The same report also found that for every $53 of NMTC investment there was an additional $47 of investment from other sources, including $23 of investment from public sources.

Although the NMTC is arguably a more streamlined program than the EC, RC, and EZ programs which involve many disparate components, its structure still is perhaps overcomplicated, with a 2010 GAO report concluding that it "could be simplified." [29] In addition, although it supports many different types of investments, more than half of investments through the NMTC are for the development or leasing of real estate as opposed to operating businesses that can, if they survive, have greater potential for expansion and job growth. [30] Investors using the NMTC have favored real estate at least in part because of the structure of the program; a report from the Federal Reserve Bank of St. Louis pinpoints two reasons that the program tilts towards real estate: it raises fewer concerns about compliance with the program's regulations and location requirements, and real estate investments have longer time horizons and can therefore use the tax credit throughout the seven year holding period without worrying about realizing a return on its capital within that period. [31]

The financial structures used by NMTC claimants have become increasingly complex and guidance from the Department of the Treasury has failed to keep pace with changes in the program.[32] Clear reporting by NMTC projects is necessary to track the success of the program in creating new businesses, but, because of inadequate reporting, GAO was unable to determine how much equity remained in the NMTC projects after the 7-year credit period and the number of NMTC projects that ultimately failed.

While effective in some areas, the NMTC is not structured to induce the kind of larger-scale investment that can accelerate the revitalization of an entire community. The 2013 Urban Institute report found roughly a third of the projects to be less than $500,000 in size and nearly 80 percent under $20 million. And, while it may have an effect on marginal sources of investment—investors who were on the fence about investing in an area

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but who now would because of extra incentives—it may not be as effective at attracting new investment. A 2007 GAO report showed that the average expected return on investment for NMTC projects decreased from 8.2 percent in 2003 towards the start of the program to 6.8 percent in the years that followed.[33] In 2014 the GAO described how NMTC projects typically take advantage of other public programs to subsidize new investments, underscoring the difficulty in pinpointing the impact of NMTC alone on investor behavior.[34]

III. Weaknesses Of Past Approaches

Complexity and Underutilization

As we have shown, the evidence for the benefits of both federal and state enterprise zone programs has been largely inconclusive with even the most positive studies rarely showing little more than marginal gains in the areas covered by the programs. One reason why the evidence may be so mixed is the underutilization of the provisions available under the various programs. Existing tax structures are already complex, and adhering to the additional rules created by the enterprise zone programs is cumbersome. Enormous resources are required to organize an activity in a manner that benefits from the positive treatment, and managing a rollover, for example, within a 60 day window may seem impossible to many investors.

Utilization of all the programs' provisions has not been tracked sufficiently as mentioned above, but the available data suggests that businesses have not been taking advantage of all the available provisions for a number of different reasons. While the Internal Revenue Service does collect data on the use of some of the program tax benefits, it does not do so for all of them, and none of the data can be linked to the individual communities that claimed the benefits.[35] As a result, the majority of the available information comes from surveys conducted by the GAO. The surveys tried to assess the use of EZ and EC tax benefits, but suffered from low response rates and all of the usual shortcomings of surveys.

On the whole, the surveys do suggest that programs suffered from underutilization—businesses did not pursue certain benefits due to their overly complicated nature, lack of clear knowledge about them, or inability to qualify for all the requirements. [36] For example, respondents to a GAO survey published in a December 1998 report were asked to explain their reasons for not claiming the EZ employment credit; of the 3,117 small urban businesses surveyed about 30 percent did not qualify for the credit because their employees lived outside of the zone, 40 percent did not know about the credits, for eight percent the credit was too complicated to use, and five percent did not have a federal tax liability.

Weak or Misaligned Incentives

The underutilization is also in part attributable to the weak incentives at the heart of previous programs, which poorly targeted the goals of increased employment and investment in distressed communities. Previous efforts can logically be divided into three categories: employment subsidies, asset purchase subsidies, and capital investment incentives. However, none of the specific approaches within these categories appear to be ideal for encouraging enterprises to relocate to distressed communities and hire workers in those areas. All three categories failed to provide a direct incentive either for investing in new companies and small businesses, or for larger investments in infrastructure and capital-intensive industries such as manufacturing, both of which are necessary to revitalize distressed areas.

Past programs have relied heavily on employment subsidies to encourage companies to hire residents of covered areas. Lifting employment is a key objective of programs that target vulnerable areas, but attracting capital for the large investments in plants and equipment that are required to revitalize a city is also necessary, and employment subsidies are a very indirect method to accomplish that. Even if one assumes that the objective of the credit is to expand hiring by existing employers, the subsidies that have been tried to date are fairly weak. First, the credits are generally small—for example a 20 percent tax credit on the first $15,000 of wages paid under an EZ amounts for $3,000—and may be too small to encourage an employer to hire a new employee from a distressed community given training and other indirect labor costs. In addition, since the credits are usually not refundable, an employer does not receive a benefit unless the business is profitable, which is frequently not the case, particularly for startup companies. Because most of the credits from programs like the federal EZ and RC programs only apply to the first several thousand dollars of wages paid to employees, they may also distort the hiring decisions of companies located within the zones; instead of hiring one worker for $30,000, they may hire two workers for $15,000 in order to twice receive the enterprise zone credit of 20 percent on the first $15,000 in wages. Accordingly, the wage subsidies may provide perverse incentives to avoid advancing workers up a career ladder. Finally, to the extent that wages do increase, then workers may decide to move to different neighborhoods. In some designs, firms can lose access to subsidies through such eventualities that are often beyond direct control.

The second two commonly used policies, asset purchase subsidies and capital investment incentives, have been targeted at expanding investment opportunities, another important challenge facing revitalization efforts. Asset purchase subsidies suffer predominantly from restrictive definitions that were mentioned above—in order to qualify as an EZ business, the scope of the business' operations must satisfy a number of different criteria. [37] The qualified property clauses also create difficulties in the ease of application of these provisions. Examples of provisions that suffer from the problem of overly restrictive definitions include the enterprise zone tax-exempt facility bonds and the RC commercial revitalization deduction. Loosening some of these restrictions or adopting a new structure might prove to be significantly more effective.

Specific investment incentives have also been used with the goal of increasing investments within a distressed community. The partial exclusion of the gain on sale of an EZ asset is one example of this type of policy. The exclusion is 60 percent for an enterprise zone business, higher than the 50 percent that applies for ordinary qualified business outside the EZ. [38] It is more tax efficient for a business to invest in flow-through entities than to utilize this provision, so it is rarely used.

The other provision in this category is the exemption for capital gains tax on qualifying RC business held for more than five years. This incentive has become mostly outdated with the introduction of the capital gains exclusion for small business stock held for more than five years by the Creating Small Business Jobs Act of 2010, which was enacted in September 2010. These two provisions are not identical since the current law only applies to small businesses, so the gain cannot exceed $10 million or 10 times the taxpayer's aggregate basis in qualified stock of the corporation that is disposed of during the taxable year; however, it serves a similar purpose within the tax code. Targeted efforts to revitalize depressed areas should be specifically tailored to their needs and simple enough to use without large obstacles, rather than replicating efforts applied to the entire country.

Restrictive Scope

In addition, restrictions on the size of investment that can qualify discourages large well-capitalized investors from participating, a factor that makes the switch to the positive Nash equilibrium where investors return to the distressed area because they are comforted by the safety of numbers less likely. Such restrictions exacerbate the first-mover problem. A good candidate for a first-mover would be a large diversified investor that could spread the risks of such investments broadly, and perhaps invest in a critical mass of enterprise all at once. If only small investments qualify, then complex coordination is an essential element of success.

Where public infrastructure is poor, it can be especially difficult to entice enough first-movers to step in and invest to the point where infrastructure will improve and tempt other businesses in. While incentives such as the ones included in the EC, EZ and RC programs may be sufficient to keep investment going where it has already started, they may be too weak to convince businesses to make the first move.

Although the NMTC is structured differently from the EC, EZ and RC programs, it too utilizes an organization framework that is not optimal for many investors. The approval process for the NMTC can be bureaucratic and compliance cumbersome, creating relatively little draw for interested investors. The NMTC also requires a seven-year commitment. While there's an obvious and positive role for patient capital in this area, many investors will find that too restrictive, and ultimately much of the investment through the program over the last decade has been in real estate. While such investment is often helpful to depressed areas, it is not the type of job-generating activity that we hope to incentivize through the alternative vehicle we introduce below.

Interaction with Other Programs

The General Accounting Office found that NMTC projects commonly utilize other sources of public funding: 62 percent of projects initiated between 2010 and 2012 received funds from federal state, or local public sources.[39] Current Treasury guidance limits the ability of projects to use the NMTC in combination with the Low-Income Housing Tax Credit, but there is not specific guidance on its use with other tax programs.[40] According to the GAO, the most frequent tax programs paired with the NMTC were historic tax credits and tax exempt bonds for private nonprofit education facilities. These other programs will have separate qualification requirements, and if the viability of certain projects depends on the combined subsidy of these programs, an additional obstacle could arise from these other requirements.

Absence of Force Multipliers

In a broader sense as well, previous programs left many potential sources of investment untapped. There was no structure in place to encourage investors to exit existing investments, for example, and bring their realized gains into enterprise zones. There also was not a structured way to involve intermediary groups, such as banks, private equity, and venture funds, in investing in enterprise zones, although these groups generally can bring large resources to projects and have the potential to invest in companies that may thrive within an area. The emphasis on individual businesses instead of larger structures and institutions may indeed be part of the reason for the tepid results of enterprise zone programs.

The checkered results of the studies evaluating previous attempts can be attributed to misaligned incentives and a weak set of policies, yet economic theory supports targeted assistance to depressed areas. Given that, and the significant geographic disparities that are evident in the data since the Great Recession, alternative designs may well be a preferable policy option to reinstating the questionable programs of the past. A simpler, targeted approach may be warranted to have a significant effect on employment and investment in the given area.

IV. New Model For Attracting Private Investment Is Needed

For political and fiscal reasons, large-scale public sector investment is unlikely to happen anytime soon, and must be supplemented by private sector investment to support robust economic growth. Private sector investors have little current incentive to invest in higher risk ventures in economically depressed communities, but the return on investment for doing so may increase if the existing friction could be deferred or eliminated.

The recovery has been particularly kind to investors in the stock market since the recession. Since early 2009, the Dow Jones has almost tripled, rising almost 12,000 points, and in 2013 alone, investors in the S&P 500 saw gains of over $4 trillion. An analysis by the Economic Innovation Group estimated that the amount of unrealized capital gains held by U.S. investors stood at roughly $2.26 trillion as of year-end 2014—a significant increase in the five years since the recession. The explosion in unrealized capital gains and cash holdings presents an opportunity for policies that create new incentive for private investors to redeploy capital to regions in need of economic development.

It is beyond the scope of this effort to develop a detailed proposal, an effort that we leave to future research. However, in this section, we sketch a new approach to geographically targeted economic policy that could be far more effective than those tried in the past, and at the same time appeal to policymakers of every political persuasion. Our key observation is that existing and prior approaches have not harnessed the power of intermediaries such as private equity firms, banks, venture capitalists, mutual funds, and hedge funds. By focusing on often small individual businesses, policies have implicitly required an unrealistically large amount of coordination among potential investors, and hence, have failed.

Consider, as an alternative, a structure analogous to that of a venture capital firm or mutual fund company, but specialized in development investments in businesses in predetermined locales. These specialized investment vehicles, which could raise capital from a mix of individual and institutional investors, would operate in targeted locales, and special tax provisions that are established for them would apply so long as the investments stayed within qualified geographic areas. One key advantage is that they are structured so as to allow partners to pool their resources and invest in numerous projects at any given time in a highly nimble fashion.

This structure would be much more attractive than previous designs. In particular, firms would emerge that would specialize in pooling investments, but onerous conditions such as the 60-day requirement would be unnecessary as money could easily sit on the sidelines for longer periods as the funds seek profitable investment opportunities. This would help to counteract the first-mover problem described above, in which any one investor has no hope of shifting an area from an equilibrium of decay to an equilibrium in which public investment and private enterprise conspire to spur renewal. By pooling assets, the risk to any one investor is limited. They would also have the capacity to move a high volume of investments into depressed communities at relatively low cost to the Federal Government.

A number of important options must be considered when devising the special tax provisions to be applied to investments in distressed regions. One key consideration policymakers might weigh heavily is an objective to make investments into economically depressed communities an easy and attractive option. There are a number of possible policies that could potentially have a major effect on such choices. For example, unrealized capital gains might be rolled over into special funds constrained to invest in distressed communities, with the capital gains taxed only if the money is withdrawn from the qualified funds down the road. A similar treatment could apply to direct investments in enterprises within the qualifying investment zones. Depending on how generous Congress would like the incentive to invest to be, the capital gains basis of the unrealized gain could be adjusted/"stepped up" in some manner as well. The generosity could be linked to the type of investment, with investments in infrastructure, for example, receiving more generous treatments. An alternative or complementary structure would be to treat funds that invest in distressed communities as 401k investments, allowing individuals to deduct investment into qualified investment vehicles in the year that they are made, accumulate gains tax-free, and then pay capital gains tax upon withdrawal of the funds. Alternatively, a Roth structure could be used under which individuals would invest post-tax income but accrue gains that would be tax-free when realized.

While the exact specification of target areas is outside of the scope of this paper and should receive further research, it is worth noting that, under a model as described above, the target investment zones could conceivably be scaled to the size of cities to maximize their potential impact. Partnership and collaboration between large funds and municipal governments could be valuable. Clearly, legislation to create these new investment structures would have to establish a process that identifies target areas in a transparent and orderly fashion, based on objective economic criteria such as the area's unemployment rate, foreclosure rate, labor force participation rate, or even its disaster zone status.

V. Conclusions

A confluence of factors motivates our proposed actions in this area. First, the geographically uneven nature of the current recovery, along with the heightened costs to families stuck in weak local economies with inadequate public and private investments, can usefully be viewed as both a crisis and an opportunity. Second, as we have noted, a very large stock of savings in the form of unrealized capital gains has built up in recent years. Third, policy measures to incentivize private investment in disadvantaged areas have largely been unsuccessful. The New Market Tax Credit is a notable exception, but here too, complexities may be restricting the scope of investments in ways that fail to tap potential growth and jobs.

Over the past two years, these factors have led to renewed interest and attention from policymakers in developing regional incentives programs to address the problem of distressed communities. For example, President Obama has discussed a "Promise Zone" program, while Rand Paul introduced the idea of "Freedom Zones," both of which are aimed at increasing investment in economically weak areas. The NMTC has the support of a bipartisan, bicameral coalition of legislators calling for it to be made permanent. These proposals speak to the desire for geographic preference programs, and show a real and continued interest on the part of the policy community in addressing issues posed by distressed communities.

In this paper, we look of the debilitating aspects of the uneven economic recovery to the overall U.S. economy, and analyze the impact of past and existing geographically targeted policies designed to encourage economic development in distressed areas. We find that the success of such programs has been limited for several major reasons: a mismatch of incentives and goals in many programs; weak and too narrowly targeted incentive structures that fail to foster sufficient investment to create a positive equilibrium were sufficient capital enters an area; bureaucratic requirements that are not offset by small rewards; and finally, a structure that does not tap all potentially available sources of investment funds. However, public incentives to attract private sector capital remain important, and so we have sketched a proposed new structure that could offer the potential to succeed where past approaches have failed. This approach will allow for better-targeted incentives to increase investment in distressed areas, along with a more streamlined process for making these investments.

In our view, policies promoting the establishment of investment funds specifically designed to allow all Americans to invest in the restoration of depressed areas could serve many positive goals. Most importantly, in a resource-constrained environment, such funds could provide the capital needed to reshape our most distressed communities by incentivizing those who have benefited from the American dream to invest in ways that seek to serve the common good. In addition, one could imagine that it would become a social norm that, for example, companies and/or individuals would invest a small fraction of their savings or profits in funds that invest in distressed communities. If these funds succeed in establishing a new equilibrium where investors flock to distressed areas because they are confident that other investors will as well, then the investments will also have the potential to be highly profitable, which would feed a virtuous cycle. In doing so, the program would partially address widening inequality and lack of economic mobility in targeted areas, but do so in a manner that relies on markets and new enterprise to help the poor. As such, policies in this area may well become vehicles for aligning the interests of a wide variety of political stakeholders, garnering the kind of broad bipartisan support that has become a rarity in the current political climate.

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About the Authors

Jared Bernstein and Kevin A. Hassett are the Co-chairs of the Economic Innovation Group's Economic Advisory Board.

Jared Bernstein is a Senior Fellow at the Center on Budget and Policy Priorities. From 2009 to 2011, Bernstein was the Chief Economist and Economic Adviser to Vice President Joe Biden, executive director of the White House Task Force on the Middle Class, and a member of President Obama's economic team. Bernstein's areas of expertise include federal and state economic and fiscal policies, income inequality and mobility, trends in employment and earnings, international comparisons, and the analysis of financial and housing markets.

Kevin A. Hassett is the State Farm James Q. Wilson Chair in American Politics and Culture at the American Enterprise Institute (AEI). He is also a resident scholar and AEI's director of economic policy studies. Before joining AEI, Hassett was a senior economist at the Board of Governors of the Federal Reserve System and an associate professor of economics and finance at Columbia (University) Business School. He served as a policy consultant to the U.S. Department of the Treasury during the George H. W. Bush and Bill Clinton administrations.

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[10] See Sections 1391-1393 and Section 1400E for exact criteria and processes.

[11] Section 1397B.

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