The Economics of Subsidies for Community Development: A Primer[7]

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Introduction

Subsidies are ubiquitous in modern market economies such as the United States. Our tax code is rife with special provisions that subsidize some endeavors at the expense of others. The government also subsidizes activities through direct provision, payment to private organizations, or regulation. Subsidies for housing (which benefit from the tax deduction for mortgage interest payments along with many other smaller subsidies) and some forms of agriculture are two examples of subsidies that affect nearly everyone. In essence, virtually every citizen of the United States—and nations with similar economies—is a direct or indirect beneficiary of subsidy programs.

Yet the term "economic subsidy" has a negative connotation in many circles. Subsidies must be paid for by taxing other activities and endeavors more heavily, distorting market incentives. The predominant view is that an activity worth undertaking must meet the market test: there must be sufficient demand for the private sector to profitably engage in the activity. The need for a subsidy is a signal that the activity fails the market test, and so may not be worthwhile. Even if there is a consensus that a subsidy largely benefits a group that society would like to help, out of considerations of equity or economic justice, a question arises: why not just give direct monetary grants to those who need them? Or if a subsidy is to be used, why not directly subsidize labor earnings? Even if one is concerned primarily with economic justice and equity, subsidies may not be an efficient means of advancing these goals.

Advocates of this view find some support in economic theory. It has long been recognized by economists that the market mechanism has the desirable property that, using the metaphor introduced by Adam Smith in his *The Wealth of Nations* (1776), individuals are led by "an invisible hand" to promote the public interest. Subsidies, by altering the prices at which goods and services are exchanged, may interfere with the functioning of the invisible hand. However, Smith recognized that there are limits to the extent to which the invisible hand can be depended on, and later generations of economists clarified the sense in which a laissez-faire market economy promotes the public interest and the necessary conditions for it to do so.

Free-market economies promote the public interest, in the sense that they tend to promote an efficient allocation of economic activity and resources. The market mechanism leads to activities being undertaken only as long as the benefits of further activity equal the incremental cost. In a sense, market forces result in automatic benefit-cost analyses guiding decision-making. However, many circumstances bring about "market failures"—the market mechanism breaks down and the actions of the unfettered invisible hand may lead to undesirable outcomes. When market failure occurs, a situation arises that economists refer to as economic inefficiency: the potential to make someone better off without making anyone else worse off—in other words, when there is a 'free lunch.' In contrast, in the absence of market failure, the free market produces economic efficiency. Subsidies can be viewed as distorting the benefit-cost calculus implicit in market decision-making, leading to the economically inefficient outcome described above.

Of course, society values more than just efficiency. In the absence of market failure, the resulting distribution of opportunities and resources is efficient in the economic sense, but it may still strike many as inequitable. There is nothing in the market mechanism to prevent persistent poverty and

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[7] The opinions expressed in this essay are those of the author, and do not necessarily reflect the views of the Federal Reserve Bank of Boston or the Federal Reserve System. The author thanks participants at the November 2009 conference on *Smart Subsidy for Community Development* held at the Federal Reserve Board of Governors for their comments on the ideas presented in this primer.

unacceptably high levels of inequality. Social and economic policy goals naturally encompass both equity and efficiency considerations, and many maintain that norms of equity and justice point to some individuals and households being in need of assistance. However, it is not enough for advocates of subsidy programs to simply show that the subsidy benefits a deserving group. The question that must be addressed is whether a subsidy provides that help in the most cost-effective manner. In the absence of market failure, the general presumption by economists is that subsidies will fail this test.

In the aftermath of the recent financial meltdown and "Great Recession," most readers will need little convincing that market failure does occur. The economic approach to the design and analysis of subsidies is still relevant and important, for two main reasons. First, economics can help guide practitioners to design cost-effective programs. Economic analysis can highlight where subsidies are effective in meeting social goals (which encompass both efficiency and equity considerations), and where subsidies are wasteful or distorting. Avoiding distortions and correcting market failures can help a program budget achieve more of its objectives and come closer to its overall aim. The current crisis has precipitated many instances of market failure: businesses and consumers being denied access to credit; displaced workers having difficulty finding new jobs; and deteriorating foreclosed properties generating blight in some neighborhoods. It is important for practitioners to be able identify economic distress caused by market failure, and to respond with appropriate proposals.

A second reason for analyzing subsidies through the lens of economic analysis is that in this era of fiscal austerity, nearly all government expenditures, both explicit spending and implicit "tax expenditures," are coming under close scrutiny. In order to survive, programs will have to be well designed and capable of passing benefit-cost tests. Many public subsidies do little to promote economic equity, and rather than correcting for market failure, they induce distortions in economic decisions and behavior; such programs may justifiably be scaled back or terminated when they come under increased scrutiny. In contrast, well-designed subsidies for community development have the potential to advance both equity and efficiency goals simultaneously. Practitioners need to be prepared to explain how subsidies for their programs differ from the more wasteful ones that many policymakers and others may think of.

This essay provides a primer on the economics of subsidies, with special application to the role of subsidies in community development. The overall goal is to outline the appropriate role of subsidies for community development, with an eye toward using subsidies to improve program design and enhance cost-effectiveness. The exposition is consistent with the standard economic framework underlying benefit-cost analysis, but it makes only minimal use of economic jargon. The first section provides a working definition of subsidy and a discussion of the types of programs and policies that provide subsidies. The next section discusses the goals of subsidy programs and the circumstances in which they are desirable or undesirable. The third section discusses subsidies in the context of benefit-cost analysis and addresses some possible controversies in project evaluation arising from conflicting goals and values. The essay concludes with a brief discussion of the implementation of subsidy programs, when economic considerations must be melded with political and noneconomic concerns in order to for programs to be viable and effective.

What is a Subsidy?

"Subsidy" is a term commonly used in ordinary discourse, but for our purposes it will be helpful to give the term a reasonably precise working definition:

> *A subsidy is a form of assistance provided by the government to a subset of the public that lowers the cost of producing a good or the price that a consumer pays for a good.*

This definition encompasses a fairly wide range of government policies, including goods and services provided below-cost directly by the government; goods and services given favorable tax treatment; and government regulations that indirectly lower the cost of particular goods or services.

The variety of forms that subsidies may take is perhaps best conveyed through example, and housing provides a particularly rich range. Public housing authorities in many cities provide services directly to low- and moderate-income families who rent apartments in publicly owned and managed complexes. The rents are set at below-market rates, providing a direct subsidy to tenants financed by the housing authority's budget.

Although public housing projects are the most visible form of subsidized housing, housing subsidies take many other forms. For example, the Low Income Housing Tax Credit (LIHTC) program provides tax credits to developers of rental housing affordable to low-income families. This program creates a complicated chain of subsidies and is a good example of a subsidy in which the direct recipients are not the ultimate beneficiaries. Rather than directly providing subsidized housing, the LIHTC program subsidizes the development of low-income housing. Low-income families are the ultimate beneficiaries of the program through the expansion of the stock of affordable housing, although they are not the direct recipients of the tax credits. The developers of the housing initially receive the credits, but they also incur costs associated with adhering to rules designed to insure that low-income families benefit. The developers generally sell the tax credits to investors who finance the projects. The investors who buy those tax credits may appear to be the beneficiaries, but since they have to pay for the tax credits (presumably at a fair market rate), they are actually simply using the tax credits to reduce their tax liability.

Low-income households are the primary beneficiaries of the LIHTC program, the largest housing subsidy program in the United States. However, the deduction for home mortgage interest payments in the U.S. federal income tax, along with the failure to tax the implicit income flow from owner-occupied housing, together disproportionately benefit relatively high-income households, dwarfing all other housing subsidies. Homeowners' consumption of housing services is effectively subsidized at a rate equal to one minus the homeowner's federal marginal income tax rate. Because high-income taxpayers tend to have a higher marginal tax rate and consume a larger volume of owner-occupied housing than low-income households, the value of tax-related subsidies for owner-occupied housing tends to increase with income.[8]

Goals of Subsidy Programs

Standard economic theory offers two broad rationales for how subsidies could improve free-market economic outcomes:

- By providing resources to the poor and underprivileged.
- By correcting for the failure of the market mechanism to create an efficient allocation of goods and services.

The first rationale concerns the goal of economic justice: well-designed subsidies have the potential to bring about a more equitable distribution of economic well-being than that generated by an unfettered free-market economy. In contrast, the second rationale concerns the role of subsidies in correcting for market inefficiencies. The relative importance of the two rationales will vary from case to case, and sometimes only one will be of substantial importance. However, in many cases related to

[8] For an analysis of the use of tax subsidies to promote homeownership see Richard K. Green and Andrew Reschovsky's piece in this publication, "Using Tax Policy to Subsidize Homeownership."

community development, both rationales are operative. In these cases, subsidies may simultaneously generate a more just distribution of economic well-being while also promoting more efficient operation of the market economy. Although much of economic policy analysis is concerned with the trade-off between the primary economic goals of equity and efficiency, some subsidies for community development may advance both goals.

Although the equity goal is likely paramount in most community development programs, our exposition will first discuss the sources of market failure and how subsidies may help to improve economic efficiency. We then turn to discussion of the equity goal and the role of subsidies in promoting a more just distribution of economic well-being. The reason for emphasizing market failure in this essay is simple: in the absence of market failure, equity goals will generally be best met by providing direct cash assistance to those in need. When a subsidy also corrects for market failure, equity goals may be met more cost-effectively through community development subsidies rather than through cash assistance.

Market Failure

When a free-market economy is working well, it achieves an efficient allocation of goods and services, i.e., it is impossible to make any one person better off without making at least one other person worse off. This is important. If it is possible to make someone better off without making someone else worse off, then, of course, we would want to do so—but efficiency in allocation does not say anything about whether the resulting distribution of well-being would be regarded as fair. This is the reason that equity and efficiency are generally treated as separate normative goals of economic policy.

There are many circumstances under which the free-market mechanism will not result in economic efficiency: what economists call “externalities” or “public goods,” information asymmetries among market participants that cause some markets to function poorly, and market power. We will briefly examine each of these sources of market failure.

Externalities and Public Goods

Usually, people or firms who engage in an activity that benefits others are fully compensated for their efforts. Economists use the term “externality” when a person’s or firm’s actions affect others in a way that is not internalized by the market mechanism. For example, consider the possible chain of events when a building owner renovates an empty, run-down building. The neighborhood’s streetscape will look more attractive, benefitting everyone who lives or works nearby. As the previously unused property becomes occupied, the neighborhood may also be perceived as safer and more stable.

The building owner who paid for the renovation receives only a portion of the economic benefits—the stream of rental income from the property, or the increase in its resale value (one or the other—considering both would be double-counting). However, a substantial portion of the benefits may accrue to nearby residents, workers, and property owners, who now enjoy a more pleasant, and possibly safer, neighborhood. The private economic return to further property improvements by building owners increases as a result of the initial renovation. This may lead some of these owners to undertake their own renovations, potentially creating a “virtuous circle” of private actions that generate positive externalities, both directly benefiting others and increasing the chance that others will undertake such activities.

The level of positive externality-generating activities undertaken in a laissez-faire economic environment will be unacceptably low. The reason is that, by definition, the parties who undertake the positive externality-generating activity are compensated for their investment with less than their full share of the benefits. If the persons or organizations undertaking the externality-generating activity also received in compensation for their investment the value of their share of the benefits that accrue to

others who did not invest in the activity (the external benefits), that would be a proper and economically efficient incentive for investors to undertake the activity. However, because only a fraction of the total benefits accrue to the persons or organizations undertaking the activity, those parties stop short of investing in the activity to an economically efficient extent. This is the essence of the market failure associated with the existence of externalities.

Returning to our example, owners of derelict buildings would be more likely to undertake renovations, and would perform renovations that generate greater externalities, if they were compensated for the full value of the benefits that accrue to others. In this case, a subsidy would enhance the efficiency of the market. A subsidy to building renovations equal to the value of the external benefits of the project (that is, the benefits that are not captured by the owners through increased rents or property values) would produce an economically efficient level of renovation activity. In making renovation decisions, building owners would then act as though they were receiving all of the benefits of the renovations—exactly what is needed for economically efficient decision-making.

How could this approach be implemented? After all, it is difficult if not impossible to determine the precise value of the external benefits of any project. From the standpoint of the building owner, it is simply a case of the improvement project's failureto generate sufficient profits, considering the risks. A developer will require a subsidy to undertake the project. It is up to policy analysts to determine whether a subsidy is justified, given the externalities generated by the project and the alternative possible uses of the public funds.

Externalities can be negative as well as positive. The best-known example of a negative externality is pollution: the polluter accrues only a portion of the total cost of his actions. Some of the cost falls on other people or firms, and the polluter has an incentive to pollute more than the economically efficient amount. The classic policy solution for pollution externalities is to impose a tax on pollution at a level such that the polluter acts as though it is incurring all of the costs of pollution.

A given situation can be viewed as involving either positive or negative externalities. For example, instead of viewing the renovation of a derelict building as generating positive externalities, we could instead choose to view the failure to renovate as generating negative externalities. Leaving a building in derelict condition not only reduces the rent the building owner can command, but also depresses the rent that may be charged by the owners of nearby properties and may contribute to the general decay of the neighborhood. From this vantage point, the natural policy solution now seems to be a tax on the failure to keep the building in decent condition. If the tax were set to reflect all of the costs that the derelict building owner imposed on others (and importantly, if the tax changed to reflect the change in these external costs whenever the owner engaged in maintenance or renovation projects that changed the level of external costs imposed on others), the owner would be guided to engage in the economically efficient level of maintenance and renovation activity.

Either a subsidy for building renovations or a tax on allowing buildings to fall into disrepair can correct the market failure resulting from the externalities associated with the effect of the condition of a building on the surrounding neighborhood. Both tax and subsidy schemes can lead to economically efficient solutions, but the distribution of gains and losses differs with the policy solution chosen. Building owners will certainly prefer receiving a subsidy for renovation to being taxed for not maintaining their buildings! The tax and subsidy schemes may also differ in their practicality and political feasibility. Tax proposals tend to generate more heated political opposition than proposed subsidies do (although the revenue to pay for subsidies must come from taxing something!). It may also be easier to design a subsidy for building improvements (where expenditure is an easily documented measure of the subsidized activity) than it is to design and implement a tax on the failure to maintain a building, which would require a quantitative measure of the degree to which building maintenance falls below a mandated standard.

In addition to the subsidy and tax policy solutions to market failure resulting from externalities, it is often possible to devise a regulatory policy solution. If the regulatory authority can determine the economically efficient level of an activity (which, in practice, will be difficult), a mandate to maintain this level can be adopted. There is a close connection between this solution to the externality problem and the tax approach outlined above. A regulation enforced by levying fines is essentially a tax on the negative externality. In the end, the particular policy solution chosen to address the externality problem will likely depend on a combination of political feasibility and administrative practicality.

What economists term "public goods" are closely related to externalities. In economic theory, a "pure public good" is a good or service that satisfies two criteria: first, any one person's enjoyment of the good does not detract from any other person's enjoyment of the good; second, it is impossible to exclude anyone from enjoyment of the good. The classic example is that of national defense services. Having one extra person enjoy the benefits of national defense does not take away anything from the benefits any other person enjoys from national defense. It is also impossible to exclude any national resident from the protection offered by national defense. One can easily see the connection between externalities and public goods—a pure public good is one that generates externalities that affect everyone. Profitable provision of pure public goods by private unsubsidized firms is not feasible. Because no one can be excluded from enjoying pure public goods (by definition), no one has to pay for a public good in order to enjoy it; thus the only revenue would come from voluntary donations. Pure public goods need to be supplied either directly by the public sector or by heavily subsidized private firms.

There are very few examples of pure public goods, but they are still relevant for our discussion. The polar opposite of a pure public good is a pure private good—a good or service that affects only the person who directly consumes it; in other words, a good that generates no externalities. A free-market economy will generally automatically ensure that an economically efficient quantity of a pure private good is produced and consumed. Anything between the polar cases of pure public goods and pure private goods can be considered impure public goods. For these goods and services, there is a potential need for subsidies to ensure an economically efficient level of provision. Although most goods arguably fall somewhere in the continuum between pure public goods and pure private goods, in many cases the degree of to which something is a public good is sufficiently small to be of little concern for public policy.

Neighborhood amenities such as parks, sidewalks, lighting, and public safety have a strong public good component. They are valued in their own right, but are also complementary to economic development. Amenities make private development more likely to become profitable, or at least require smaller subsidies.

More generally, neighborhood vitality itself can be considered a public good. Like other public goods, it will tend to be underprovided by private market mechanisms. All neighborhood stakeholders benefit from the vibrancy of the area, but because the benefits are shared and diffuse individual stakeholders lack sufficient incentives to undertake the investments needed to restore a neighborhood to health, a suboptimal amount of neighborhood vitality would be provided without intervention to correct the market failure. In this type of situation, subsidies for the development of neighborhood infrastructure can correct the market failure and set the stage for profitable private development.

Asymmetric Information

Another source of market failure arises when the market for a good or service performs poorly as a result of information asymmetries between buyers and sellers. As is often the case, especially in insurance and financial markets, one party to a transaction has access to pertinent information that the other party lacks. Consider the case of a potential borrower who has a well-thought-out plan to expand a small business and is confident of her ability to repay a loan for this purpose. Unless the borrower has

substantial collateral and a documented history of good credit (leading to a high credit score), she may have difficulty obtaining a bank loan to finance the expansion. Although based on her own private information she is a good risk, from a bank's perspective, she is a high-risk borrower and would likely be turned down for a loan. She would be able to go ahead with her expansion plans only if she could finance the project with family wealth or through wealthy personal connections.

It might seem somewhat puzzling that a bank would turn the borrower down outright, rather than just making a loan at a very high interest rate. However, this is a perfectly rational response, because the bank knows that if it offers high-interest-rate loans to potential borrowers for whom it has relatively little information, there will be a tendency for the highest-risk borrowers to accept the terms of the offered loans and for the lowest-risk borrowers to turn down the loan offers. The lowest-risk borrowers will be more likely to convince family members and friends to supply financing on more advantageous terms than those offered by the bank, and so will tend to turn down the bank's loan offer. The highest-risk borrowers will not want to jeopardize the funds of personal contacts and family members (or will not be trusted by those who know them well) and so will be likely to accept the loan offers. As a result, any loans made will likely be unprofitable even if high interest rates are charged.

The market failure in this case arises from the lack of a well-functioning market for loans. Because of information asymmetries, some borrowers who are actually reasonable risks will not have access to financing. This leaves potentially profitable investment opportunities unexploited, leading to economic inefficiency.

Government policy can sometimes play a role in at least partially alleviating this form of market failure. Government intervention in lending programs is often motivated by the problem of potential borrowers who lack collateral, making them either unable to borrow or able to borrow only on very disadvantageous terms. The government subsidies or guarantees of repayment common in student loan programs help to correct for this type of market failure. In community development, similar problems affect the ability of community groups to obtain loans necessary to advance their projects. The groups' status as not-for-profit entities and lack of collateral are often obstacles to obtaining loans through traditional channels. However, unlike the case of externalities, where the link between subsidies and correcting market failures is clear and direct, the case of market failure in loan markets is more nuanced, and the form that subsidies should take is less clear.

The Community Reinvestment Act (CRA) may be viewed as an attempt to address credit markets that function poorly due to market failures associated with information asymmetries. By mandating that banks serve all communities within geographic areas where they are chartered to do business, the Act provides a de facto subsidy to lending in low and moderate-income neighborhoods. Low-income neighborhoods may be particularly vulnerable to information problems. Lack of access to collateral, difficulty in documenting qualifications, and weak networks of informal sources of credit may all be prevalent in low-income neighborhoods. Lending requirements embedded in the CRA may help to circumvent these problems. The CRA may also help to bridge other forms of market failure. For example, a basic level of financial literacy among the citizenry can be regarded as a public good—it contributes to a better-functioning economy. By promoting access to financial services, the CRA likely contributes to this public good. In addition, to the extent that it promotes redevelopment of low-income neighborhoods, the CRA may also help to alleviate externalities associated with urban blight. The CRA is also an important tool for addressing market failure associated with high fixed costs of serving low-income communities, as discussed below.

Market Power and High Fixed Costs

Among the general public, the most common concern about monopolies and other firms with significant market power is that because their profits will be greater without significant market competition,

consumers will lose out. To economists, however, the root cause of the market failure associated with monopolies is that monopolists charge consumers a price that exceeds the marginal cost of production. Consumers will purchase a good or service only if the subjective benefit ("utility" in economic jargon) is at least as great as the price they pay. So, in a monopolized market, the marginal benefit to consumers of the monopolist's output is greater than the marginal cost of production. If more were produced and sold, then the added benefit to consumers would more than cover the additional production cost. The fact that more is not produced is the source and evidence of the market failure.

Monopolists do not necessarily generate above-normal rates of profit. In some cases, the reason that only a single firm serves the market is that high fixed costs of operation make it uneconomical for more than one firm to operate. If the fixed costs are large enough relative to the scale of the market, then even if the monopolist exploits its pricing power, the maximum profit it can extract may actually result in a subnormal rate of return on its investment. In cases such as this, the firm will need to be subsidized if it is to stay in business.

Providers of services in some low- and moderate-income markets may fall into this category—if the market were large enough, they could survive without subsidy. However, because of high fixed costs and limited demand (which may be due to low family income in their markets), they are not economically viable without some sort of subsidy. Examples include bank branches and supermarkets, which may be missing in low-income neighborhoods because the expected volume of business is not sufficient to cover the fixed costs of operation. The high fixed costs lend these businesses some of the characteristics of public goods: everyone in the neighborhood would benefit if such businesses located nearby. Consider the case of a neighborhood supermarket. It would be viable if enough individuals increased their spending at the store, but any given individual lacks the incentive to do so because the benefit (the continued existence of the store) is shared with everyone else in the neighborhood. Providing a subsidy for the business, perhaps through below-market rent, may be necessary for it to be profitable. Businesses that are a necessary part of a community's basic economic infrastructure, such as supermarkets and banks, may be profitably provided without subsidy in high-income neighborhoods, but require subsides to be viable in low-income neighborhoods.

In the case of financial services, the CRA helps to overcome the fixed costs of serving low-income neighborhoods. By mandating that banks serve low-income areas where high fixed costs may make operations unprofitable, the CRA helps to correct for market failure.

Economic Equity

Finally, we come to economic equity, which is generally the main goal of community development organizations. Even without market failure, many members of society may not regard the distribution of well-being produced by free markets as equitable. Exactly what an equitable distribution would look like, of course, depends on value judgments, and equity goals are sometimes viewed as more subjective than the goal of economic efficiency. There is general agreement on the forms of market failure that must be corrected in order to achieve economic efficiency, but much less agreement on when the distribution of economic well-being is inequitable. For example, some people place special emphasis on ensuring equality of opportunity, while others are more concerned with the distribution of economic outcomes. Even among the latter group, there is sometimes disagreement over what aspects of the distribution are of greatest concern. For example, are we most interested in poverty alleviation, with little attention to the distribution of income over the poverty line, or is the size of the gap between high- and middle-income households also of concern?

Although there may be more disagreement over equity goals than over efficiency goals, it is clear that equity and efficiency are both normative considerations, and one cannot presume *a priori* that one is necessarily of greater importance than the other. Moreover, it is important to remember that

efficiency is only a means to an end—it is valued only because the existence of inefficiency implies that we could potentially make someone better off without making anyone else worse off. There are hypothetical examples of efficient economies that nearly everyone would view as undesirable because of a very concentrated distribution of well-being (for example, where one person reaps nearly all the gains from the economy, with little left for anyone else). There are also hypothetical examples of economies with a very equal distribution of well-being, but with such a high degree of inefficiency that the overall level of economic welfare is very low. In evaluating real policy proposals and alternatives, the relative importance attached to efficiency and equity goals will depend on the particular policy and setting. In the case of community development in low and moderate-income neighborhoods, it seems reasonable that equity goals will be paramount.

Equity and efficiency are often depicted as conflicting goals, requiring policy makers to choose between the two. In Arthur Okun's (1975) famous metaphor, using public policy to redistribute resources from the well-off to the poor is like carrying water in a leaky bucket.[9] Some of the water makes it to the destination (redistribution does occur), but some of the water leaks out and is wasted (there is a loss of efficiency). An obvious source of "leakage" in programs designed to address inequity is the administrative cost of running the program. A more subtle, but often more important, source of leakage is the distortion of the incentives introduced by many programs. For example, providing means-tested subsidies to disadvantaged people may distort the incentives they face to work and save, resulting in a loss of economic efficiency and a reduction in the effectiveness of the subsidies.

However, subsidies do not necessarily result in efficiency losses (or "leakages"). When market failures adversely affect people who have low-to-moderate income, correcting those failures can simultaneously enhance market efficiency and advance equity goals. Many of the examples discussed above pertain to market failures that adversely affect residents of low-income neighborhoods. Subsidies that help to correct these market failures contribute to equity goals while also enhancing economic efficiency. In the absence of market failure, subsidies will cause market distortions, and some of the money spent on the subsidy will accrue as wasted "deadweight loss." In contrast, subsidies that correct market failures produce benefits in excess of the monetary cost of the subsidy (in essence, a negative deadweight loss).

In addition to causing or contributing to economic inefficiency, market failure may also cause or contribute to economic inequity. For example, credit restrictions due to market failure arising from information asymmetries may be particularly severe in low-income communities, leading to reduced opportunities for entrepreneurship and economic advancement. Externalities associated with urban blight may discourage schooling and employment, leading to a cycle of poverty. In such instances, addressing market failure may be essential to advancing equity goals.

Designing programs to simultaneously address economic inequity and market failure may help to build political support for the programs and remove the stigma associated with subsidies. Rather than distorting incentives or leading to a poverty trap, a subsidy designed to correct market failure corrects a problem that prevents markets from working efficiently. Moreover, as discussed below, taking account of market failure may help to build the business case for well-designed subsidies.

Benefit-Cost Analysis of Subsidy Programs

Benefit-cost analysis is arguably the most fundamental tool of economic decision-making and is the foundation (explicit or implicit) of the business case for a proposed investment. Businesses apply benefit-cost analysis to nearly all their decisions, although they rarely refer to it as such. To a private business motivated only by profit, the benefit-cost criterion is simple: does the proposed action increase

[9] Arthur Okun, *Equality and Efficiency: the Big Tradeoff,* Washington, DC: The Brookings Institution, 1975.

profits? A careful business will take account of the uncertainty of projected future cost and revenue streams, adjusting for risk and discounting for the time-value of money. Nevertheless, the criterion is still whether profits are projected to increase—considerations of economic equity, potential externalities, and other aspects of economic welfare are irrelevant unless they affect profits.

Nonprofits, government organizations, and some businesses whose missions encompass more than profit-making have broader objectives, and as a result decision-making must include more than just analyzing the effect of an action on profits. External costs and benefits that would be irrelevant to a for-profit firm should be taken into account, as should any impacts on economic equity. External costs and benefits are more difficult to quantify than are standard accounting cost and revenue streams, but it is important to make some attempt to do so. At the very least, it should be possible to calculate the subsidy necessary to induce a private business to undertake the project. The required subsidy can then be compared to a reasonable range of estimates of the value of external costs and benefits.

Equity considerations are also nearly impossible to quantify directly into costs and benefits. One way they can be incorporated into benefit-cost analyses is by ranking projects. There are many instances of market failure and we cannot fund public expenditure or subsidy programs to address them all. Distortionary taxes must be levied to raise the funds for public expenditures and subsidies. Such taxes result in efficiency losses, so it would not make sense to fund projects to eliminate all sources of market failure. In determining which projects to fund, the distribution of benefits and costs can be analyzed, with preference given to those that advance equity goals. Alternatively, if each of the proposed alternatives is expected to have the same impact on equity, the project with the greatest net benefits, taking full account of external benefits, could be chosen.

Conclusion

This essay makes the case that economic analysis can help in determining when subsidies for community development are appropriate and justifiable. Although many of the largest subsidy programs, such as the home mortgage interest deduction, distort economic incentives and skew the distribution of well-being toward the relatively affluent, subsidies for the development of low- and moderate-income communities can not only enhance economic efficiency but also ameliorate problems of poverty, inequality, and obstructed economic opportunity.

Community development often simultaneously corrects for more than the source of market failure. A project will often generate positive externalities and also suffer from lack of access to financing through traditional sources. Subsidizing the financing of community development projects is one policy response designed to correct sources of market failure that adversely affect low- and moderate-income communities. Such subsidies may be a more cost-effective way of helping residents of these communities than either direct cash payments or direct government provision of services.

It is important to recognize that the public sector is not the only source of subsidies to address problems of inequity and market failure. Private philanthropists, foundations, and nonprofit enterprises may apply the same principles used by public-sector decision-makers, although the relative weights placed on different aspects of community development may differ between the public and nonprofit sectors. A nonprofit organization may wish to promote the provision of a specific public good or service that is particularly valued by its funders. For example, a patron of the arts may wish to subsidize programs aimed at providing public displays of art or musical performances in communities that would otherwise be underserved in this regard. Some nonprofit groups work in collaboration with the public sector and rely partly on public funds. However, even when there is no direct public funding involved, there is public subsidy implicit in the tax deductibility of charitable contributions and the favorable tax treatment of nonprofit organizations. Although direct public expenditures receive more attention, the

tax expenditures associated with charitable giving and nonprofits are an important source of funds for community development.

Community development practitioners may question the extent to which the economic considerations outlined above actually guide real-world policy-making in community development. Practical considerations such as balancing the differing interests of competing groups of stakeholders and administrative feasibility are often paramount. However, policy-making is about more than just balancing the interests of different groups of stakeholders. Projects need to start with a well-thought-out plan that can gain support among community stakeholders and funding sources. Economic analysis of the need for, and effects of, subsidies should play an important part in this process.

Stakeholders are often concerned with objectives they consider essentially noneconomic. However, many such objectives, such as placing inherent value on promoting safe and economically vibrant communities for all to enjoy, can be viewed as a combination of economic efficiency and equity goals. Having safe and vibrant communities can be viewed as a public good, and targeting subsidies to providing that good in low- and moderate-income areas is a way to advance equity objectives. When done right, benefit-cost analysis can incorporate these goals, reflecting values many practitioners believe to be missing from free-market economics, while still using the power of economic analysis to identify opportunities for the smart use of subsidies.

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