OPPORTUNITY ZONES: CURRENT STATUS AND OPTIONS FOR REFORM

Statement of

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THE OPPORTUNITY ZONE PROGRAM AND WHO IT LEFT BEHIND

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Chair Pascrell, Ranking Member Kelly, and members of the committee, thank you for inviting me to speak before you today on the important topic of Opportunity Zones.

I am a senior fellow and director of the Community Economic Development Hub at the Urban Institute, a leading research organization dedicated to developing evidence-based, nonpartisan insights that improve people's lives and strengthen communities. The views expressed are my own and should not be attributed to the Urban Institute, its trustees, or its funders.

I have spent my career studying federal community and economic development programs and policies as well as capital flows and investment. I have been actively engaged in Opportunity Zones since they were first proposed in legislation. After they were created through the Tax Cuts and Jobs Act of 2017, I worked to inform governors in selecting Zones that would productively use the incentive. Since Zones have been designated, I have analyzed selected Zones, worked with local communities and governments across the country on implementation, and contributed to field-building efforts to better deploy Opportunity Zone capital toward projects and operating businesses that meet community needs and yield significant social benefit. Further, I have conducted thorough assessments of how well Opportunity Zones have channeled capital into projects aligned with equitable development goals.

My study and analysis of Opportunity Zones is grounded in my research of an array of other federal community and economic development programs, including evaluations of the Community Development Financial Institutions Fund's New Markets Tax Credit program; the Small Business Administration's 7(a), 504, Small Business Investment Company, and microloan programs; the Economic Development Administration's programs; and the Department of Housing and Urban Development's Community Development Block Grant, Section 108, Strong Cities Strong Communities National Resource Network, and Choice Neighborhoods program. I have built a body of research on community development financial institutions, or CDFIs, and other mission-based impact investors and lenders. I study private-market and public-sector capital flows to understand which communities are successfully accessing capital, which are being left behind, and what can be done to help.

My goal with this work is to support communities that have historically lacked access to financing, both rural and urban, find the supports and resources they need to grow and to do so in a manner that creates wealth, power, and hope for all residents.

Summary

Opportunity Zones were created to address a market failure in capital markets. There are communities across the country—from New Jersey to Appalachia, Indiana to the Mojave Desert—that have been faced with severe economic distress and disinvestment for decades, stemming from a historic mix of limited or harmful private action, market determinations, and off-target or insufficient government policy. These communities' lack of access to capital harms their well-being: it prevents aspiring entrepreneurs from starting new businesses; it pushes aside families' dreams of homeownership; and it starves communities of the amenities, services, and resources they need to thrive.

Over the past four years, Opportunity Zones have become one of the most discussed pieces of federal community and economic development policy. The first year of the incentive was spent selecting Zones, writing draft rules, and educating people about this tool. Now that the rules regulating Opportunity Zones are clear, investors, local officials, developers, and businesses have robustly engaged with the incentive (although given limited reporting and disclosure requirements, we do not fully know to what degree they have done so).

From what has been publicly disclosed, hundreds of Opportunity Funds have been created, and Opportunity Zone investment is flowing. My research has also shown that Opportunity Zones have reached actors who had not been previously engaged with the community development field, and in some communities the program has catalyzed an ecosystem of community development efforts.

Nevertheless, in the years since Opportunity Zones' inception, it has become increasingly clear that their structure is preferenced against operating businesses, against smaller and rural projects, and against the types of mission-aligned projects that could deliver maximum community benefit. Although the incentive can be used to finance projects that yield community benefit, the fundamental design of the incentive makes doing so challenging at best and often impossible. As such, when Opportunity Zone projects have been impactful, they have (1) succeeded after substantial concessions and wrangling; (2) relied on highly altruistic investors who have forgone larger returns; or (3) drawn on other substantial federal, state, and local subsidies to make projects work. The Opportunity Zone program is not standing on its own two feet to produce impact or reach communities the private market is not already serving.

Today, both Congress and the Biden administration have an opportunity to ensure that Opportunity Zones do not leave any more communities behind. Rather, through reforms, Opportunity Zone can be made to benefit low- and moderate-income communities in urban and rural contexts.

Background

As has been well documented, wealth is growing increasingly concentrated among a smaller and smaller share of Americans. This creates rigid political and social systems that threaten us all. For example, rural areas get one-quarter of the per household investment that large urban areas do; Latinos, who make up 16 percent of adults, constitute just 6 percent of owners of employer firms (and those firms have just 3 percent of receipts); and Black Americans represent 12 percent of adults but just 2 percent of employer firm owners are Black (and those firms have less than 1 percent of receipts). These disparities lead to problems for all of us.[1]

It is a legitimate work of the federal government to help communities inadequately connected with capital markets achieve economic growth and allow their residents to access the resources necessary to achieve their full potential. We have many responsible and effective examples of federal programs and incentives that work to achieve these ends. Some have been around for decades, like the Community Development Block Grant and Economic Development Administration. However, we

[1] Authors' analysis of 2018 Annual Business Survey data and 2019 annual population estimates from the US Census Bureau.

also have programs such as 1031 exchanges, the mortgage interest deduction, and EB5 visas that are poorly targeted to communities of need.

Community development policy in the United States in its earlier days consistently relied on federal spending and control. I am no defender of previous iterations of failed place-based policy, such as Urban Renewal, which significantly displaced disenfranchised people, often people of color. But it is worth reflecting on where we have come in our federal community economic development policymaking.

We have gradually and consistently moved toward a model where the federal government exerts less and less control over our federal resources. First, in the Nixon and Ford era, the federal government devolved control of federal resources to states and cities via block grants. In the Carter era, the federal government took a further step back with Urban Development Action grants, granting the private sector much more control over how federal resources were used even with the US Department of Housing and Urban Development conducting project-level vetting and oversight. The Reagan-era low-income housing tax credits continued a progression of diminished federal control: they eschewed federal project-level vetting but used parameters set by housing finance agencies and a competitive application process to incentivize beneficial development. The Clinton-era New Markets Tax Credits were a further diminishment of federal influence and control: not just states but also banks, developers, nonprofits, and others began deciding how federal resources were deployed, though again a competitive process was used to drive behavior toward community benefit.

Today, with the advent of Opportunity Zones, we have come to rely on tax breaks for the wealthy and corporations to drive community development, but the top 0.1 percent of income earners have already seen their average tax rate fall by more than 25 percentage points since the 1950s.[2] The Congressional Joint Committee on Taxation now estimates that the Opportunity Zone incentive will cost the government $1.6 billion annually in forgone tax revenue, making it one of the largest federal place-based policies.[3]

I submit that Opportunity Zones mark the near complete transition to privatized federal community and economic development policy. I do not mean to imply that involving the private sector in community and economic development is all negative, but the federal government can no longer depend upon tax breaks for the wealthy to carry out its responsibilities to communities across our country. There are opportunity costs to our Opportunity Zone spending.

Where Do Limitations, Challenges, and Inefficiencies Exist?

Opportunity Zone proponents and government officials have said the incentive's goals are to spur economic development, promote business growth, create quality jobs, and, in so doing, "help address

[2] Emmanuel Saez and Gabriel Zucman, *The Triumph of Injustice* (New York: Norton & Company, 2019, 42).

[3] Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2020-2024* (Washington, DC: Joint Committee on Taxation, 2020), https://www.jct.gov/CMSPages/GetFile.aspx?guid=ec4fb616-771b-4708-8d16-f774d5158469.

the persistent poverty and uneven recovery that left too many American communities behind."[4] According to the original concept paper proposing the incentive, Opportunity Zones are intended to address a panoply of social ills related to living in areas with high unemployment and job loss, including increased illness and mortality, lower achievement outcomes for children, the breakup of families, and significant lifetime earnings disparities between those who grow up in poor versus wealthy neighborhoods.[5]

To assess Opportunity Zones' success in relation to their intended goals, my team released a report, *An Early Assessment of Opportunity Zones for Equitable Development Projects.* This comprehensive research process included over 70 in-depth interviews with project sponsors; fund managers; investors; wealth managers; developers; philanthropies; and public and nonprofit agencies working with Opportunity Zones. We asked interviewees to describe projects that were funded as well as those seeking funding, the terms of investment sought by project sponsors as well as investors, the nature of community engagement that they have observed, and other opportunities and challenges they perceived around using the incentive for equitable development.

Unfortunately, based on our interviews of people involved in Opportunity Zone projects and attempted projects to date, the structure of the incentive appears to be least workable for the projects that could have the greatest impacts on equitable development.

Opportunity Zones disadvantage high-impact projects in four crucial ways:

1. **The tax exemption on Opportunity Zone projects is structured to provide the largest financial benefits to the projects that provide the highest returns**, rather than rewarding impact investors who are willing to support projects with large social impacts. Luxury housing in appreciating neighborhoods, therefore, may receive much larger public support than, say, affordable housing projects.
2. **The incentive does little to democratize community investing or ownership**. Few people have sufficient capital gains to make Opportunity Zone investments, thus creating a narrow pool of investors to which projects sponsors can appeal. In particular, the design of the Opportunity Zone incentive fails to support investments from community stakeholders who do not have capital gains. The Opportunity Zone incentive design also does not support or encourage investment from other funds that may have a strong natural disposition to consider community investments, such as pension funds and foundation endowments.
3. **The 10-year time horizon of most Opportunity Zone investments is not long enough for many beneficial projects, such as affordable housing, health care centers, or schools**. This causes equitable development project sponsors to scramble to put together refinancing plans that may not work in a future interest rate or real estate market environment. Conversely, the 10-year time horizon is too long, too illiquid, and too fixed to encourage non–real estate business investments.

[4] See "Opportunity Zones," Nightingale Partners, accessed November 12, 2021, https://www.nightingalepartners.org/opportunity-zones.

[5] Jared Bernstein and Kevin A. Hassett, "Unlocking Private Capital to Facilitate Economic Growth in Distressed Areas" (Washington, DC: Economic Innovation Group, 2015).

4. **The financing that Opportunity Zones is designed to promote is poorly suited for most equitable development uses**. Despite its expense to the US Treasury, the incentive is a rather shallow subsidy or boost to return on the front end (through the temporary deferral and step-up in basis), while the permanent exclusion of gains is speculative. As such, Opportunity Zones largely promote market-rate private equity investment in multifamily and commercial and industrial real estate. But disinvested rural and urban Zones have complex and long-standing challenges that often require a deeper subsidy than Opportunity Zones can provide. Communities need small businesses that will create quality jobs as well as community resources such as affordable housing, schools, child care centers, and health care. Market-rate private equity for real estate is a poor vehicle to deliver these kinds of investments. It is unlikely that Opportunity Zone financing alone can unlock the small business growth or the development of community institutions and amenities that is needed to promote sizable job creation or equitable growth.

Early evidence reveals the effects of these limitations on Opportunity Zone activity. This year, research from the Congressional Joint Committee on Taxation revealed the uneven distribution of Opportunity Zone activity in designated census tracts across the country. Overall, Opportunity Zone capital has been "highly spatially concentrated … directed toward the real estate and construction sectors, and gravitates toward tracts with relatively higher educational attainment, income, density, and preexisting upward income and population."[6] The Zones that attracted Opportunity Zones investment dollars were far more economically robust than the substantial number of Opportunity Zones that received $0 in Opportunity Zone investment. To date, 51 percent of Opportunity Zone dollars have been invested in real estate firms, while 9 percent have been invested in construction firms, 9 percent have been in finance, and 7 percent have been in property owned or leased directly by Opportunity Funds.[7] Perhaps most striking, just 1 percent of Opportunity Zone tracts account for 48 percent of total investment, and 5 percent of Opportunity Zone tracts account for 87 percent of total investment.[8]

Where Congress Can Act

Now, four years since the Opportunity Zones' inception, we sit at an important crossroads. Either the Opportunity Zones incentive can stay the course, failing to fully deliver on equitable growth for the disinvested communities it is meant to serve, or Congress can chart a new path that prioritizes projects that generate substantial social impact and community benefit for low- and moderate-income residents. Changes can be made to make this incentive an effective tool for community development rather than another tax shelter for the wealthy. Specifically, Congress can do the following:

- **Support mission-driven funds that are accountable to the community:** Opportunity Zones could be changed to require a more rigorous certification process for Qualified Opportunity Funds

[6] Patrick Kennedy and Harrison Wheeler, *Neighborhood-Level Investment from the U.S. Opportunity Zone Program: Early Evidence* (Berkeley: University of California, Berkeley, 2021).

[7] Kennedy and Wheeler, *Neighborhood-Level Investment*.

[8] Kennedy and Wheeler, *Neighborhood-Level Investment*.

rather than allowing funds to self-certify. This could support mission actors, such as CDFIs. Congress could reform the incentive to give preferential treatment to CDFI-controlled vehicles. CDFIs are accustomed to taking on higher risks than conventional investors and to working with the kind of investees who have been struggling to access Opportunity Zone capital, such as small businesses and less sophisticated developers, as our own research has revealed. CDFIs have successfully mitigated these risks by providing hands-on technical assistance to their investees. A major constraint to increasing the impact of CDFIs has been the lack of equity to capitalize them—an issue the industry is actively seeking to address. A redesigned Opportunity Zones incentive could encourage equity investments in CDFIs who set up Qualified Opportunity Funds.

- **Restrict qualifying Opportunity Zone investments more narrowly:** Particularly for real estate investments, which are the bulk of Opportunity Zones projects, the legislation should be adapted to a more narrowly defined set of community needs. For instance, only real estate transactions where the operating business is the owner-occupant, commercial and industrial real estate in tracts with high vacancy rates, and housing sold or rented at below-market prices.

- **Allow only those investments that pass a "but for" test:** Evidence on how much the Opportunity Zones incentive triggers new deals is mixed. Even when improving returns for investors, most project sponsors we interviewed in 2019 and 2020 reported that Opportunity Zones were not critical for filling a financing gap or increasing the social impact goals of their venture. This means the federal government may be subsidizing investments that do not need the help. Some other federal community and economic development programs have "but for" or "substitution" tests embedded. By restricting the incentive to those projects that could only proceed with the additional help of the incentive, the total cost of the incentive would be reduced, and federal tax dollars would be reserved to incentivize new development that could not have been generated by the private market alone.

- **Restructure the tax benefits to size the incentive based on the impact:** Evidence from the Joint Committee on Taxation suggests that Opportunity Zones investments are concentrated in less distressed zones and high-return real estate projects. Congress can act to address this, for example, by deepening the step-up in basis with very strict conditions. The step-ups could be further targeted and differentiated by the level of economic distress of Zones. The best-off Zones might get no step-up in basis, the next tranche of Zones could receive a 5 percent step-up in basis, and so on. Incentives can also be adjusted based on the number of quality jobs created by the investment or the equitable development characteristics present in a project, such that it limits the greatest incentives to projects where a positive social impact is deemed likely.

- **Broaden who can invest**: There is no particularly good reason to limit incentives for community investing to taxpayers who have prior capital gains. Doing so freezes out most stakeholders in low-income communities from investing in their own revitalization. A refundable tax credit rather than a capital gains exclusion could open up opportunities for these investors. Other actors such as foundation endowments and pension funds have substantial resources (and most likely a greater proclivity than many capital gains holders to consider community investing) if an incentive can be structured to engage them.

- **Require transaction reporting**: Opportunity Funds should be required to provide basic transaction-level information on the "who," "what," "when," "where," and "how much" of all investments made as a condition of receiving a federal tax benefit.

Where the Administration Can Act

Considerable progress can be made even without congressional action. The US Department of the Treasury can consider doing the following to improve Opportunity Zones:

- **Conduct a rigorous certification process for Opportunity Funds:** Opportunity Funds should be required to be undergo a rigorous certification process to be eligible to act as a vehicle for Opportunity Zone investment, not the self-certification process that was conceived by the Treasury in 2018 and continues today. As part of this process, Opportunity Funds should be required (1) to demonstrate an intention to and plausible mechanism for investing in projects that yield true community benefit and (2) to adhere to disclosure and reporting requirements and community engagement processes.
- **Make this tool more like a "program," not merely an "incentive":** An agency or subagency (apart from the Internal Revenue Service) should be given clear administrative authority over Opportunity Zones. This work needs to be resourced. Dedicated staff are required to ensure proper oversight of Opportunity Funds and properly collect, aggregate, and share data about investments with the public. One such agency that could serve this role is the Treasury's CDFI Fund, which is tasked with similar responsibilities for the New Markets Tax Credit and has thus already developed the necessary capacity and competencies.
- **Require transaction reporting:** The Treasury already has the authority it needs to require transaction-level reporting from Opportunity Funds that answer the "who," "what," "when," "where," and "how much" of all investments made. This can be done through the certification process. To be effective, reporting should be required through a mechanism separate from a tax form. Tax forms reporting by its very design and structure discourages public reporting; although it appears to bolster reporting, it is actually a deeply flawed approach.

Conclusion

I appreciate your consideration of this testimony and welcome any future opportunity to inform Congress as it strives to ensure that Opportunity Zones both achieve real benefit for communities across the country and grow the mission-based community development finance ecosystem.