A TAILORED OPPORTUNITY ZONE INCENTIVE COULD BRING GREATER BENEFITS TO DISTRESSED COMMUNITIES AND LESS COST TO THE FEDERAL GOVERNMENT

Statement of

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CAN OPPORTUNITY ZONES ADDRESS CONCERNS IN THE SMALL BUSINESS ECONOMY?

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Chairman Kim, Ranking Member Hern, 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, along with capital flows and investment. I have been actively engaged in Opportunity Zones from the point of initial proposals. After passage, I worked to inform gubernatorial selection.

Since tract designation, I have analyzed selected Zones, worked with local communities and governments across the country on implementation, and contributed to field-building efforts with the goal of encouraging the deployment of Opportunity Zone capital toward projects and businesses that meet community needs and yield significant social benefit.

The background and context I bring to this is having conducted, or currently conducting, evaluations of the CDFI Fund's New Markets Tax Credit program; the Small Business Administration's 7(a), 504, SBIC, and microloan programs; the Economic Development Administration's programs; and the Department of Housing and Urban Development's (HUD's) Community Development Block Grant, Section 108, Strong Cities Strong Communities National Resource Network, and Choice Neighborhoods programs. I have built a body of research on community development financial institutions (CDFIs) and other mission-based impact investors and lenders. I study private-market and public-sector capital flows to understand which communities are accessing capital, which are being left behind, and what can be done to help.

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

Summary

Opportunity Zones were created to address a failure in capital markets. Communities across the country—in New Jersey and Appalachia, in Michigan and the Mississippi Delta, in the Central Valley of California and too many other areas—have faced 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 governmental policy. These communities have investable deals but may lack the ecosystem needed to translate ideas into funded projects. A lack of access to capital harms the well-being of community residents: it prevents aspiring entrepreneurs from starting new businesses, it pushes aside dreams of homeownership for families, and it starves communities of the amenities, services, and resources needed to thrive.

Over the past two years, Opportunity Zones have become the single most discussed piece of federal community and economic development policy. Much of 2018 was spent selecting Zones, drafting rules, and educating people about this new tool. Now that the rules regulating Opportunity Zones are becoming clearer, investors, local officials, developers, and businesses are engaging with the incentive—though, given limited reporting and disclosure requirements, we do not know to what degree. From what has been publicly disclosed, hundreds of Opportunity Funds have been created, and Opportunity Zone investment is beginning to flow. (Opportunity Funds are the legal vehicle through which investors with gains place capital in qualified businesses.) Considering their potential to attract new investors, leverage existing mainstream investors, and support mission-oriented investors, Opportunity Zones could be used to change disinvested communities for the better.

However, under the current legislative structure and executive implementation, the incentive is extremely open-ended. It lacks sufficient spatial targeting to the neediest communities. It lacks sufficient use targeting to projects that will truly benefit communities. It lacks any mechanism for community input or control. And it lacks any requirements around transaction-level reporting, though the certification process has the mechanism to permit it.

When Congress considers whether to renew Opportunity Zones, several revisions to the program would improve the flow of benefits to residents of disinvested communities—particularly those with low and moderate incomes. Legislative and administrative reforms are needed to ensure the federal government avoids subsidizing deals that don't need the support. Reforms are needed to avoid providing the lion's share of incentives to the best-off Zones. Reforms are needed to prevent taxpayer forgone revenues from being used locally in ways that taxpayers find incongruent with their objectives. And reforms are needed if this incentive is to be tracked with proper accountability.

Background

We cannot ignore the reality that wealth is growing increasingly concentrated among a smaller and smaller share of Americans. This concentration of wealth creates rigid political and social systems that threaten us all. When Hispanics make up 16 percent of adults but constitute just 6 percent of business owners, and those firms have just 1 percent of receipts, and when African Americans represent 12 percent of adults but just 2 percent of business owners, and those firms have less than 1 percent of receipts—it is a problem for all of us.[1]

It is a legitimate work of the federal government to help communities inadequately connected with capital markets to achieve economic growth and allow their residents to access the resources necessary to achieve their full potential. We have many responsible, 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 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, like Urban Renewal, that displaced significant numbers of disenfranchised people, often of color. But it is worth

[1] Author's calculation based on Statistics for US Employer Firms by Sector, Gender, Ethnicity, Race, and Veteran Status for the US, States, and Top 50 MSAs, US Census Bureau.

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. Like the proverbial frog, we are no longer noticing the temperature of the water we're in.

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, putting the private sector much more in the driver's seat on how federal resources were used, but with HUD conducting project-level vetting and oversight. The Reagan era low-income housing tax credits continued a progression of diminished federal control, with no federal project-level vetting, but with 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, now with not just states, but banks, developers, nonprofits, and others deciding how federal resources are deployed, though again with a competitive process to drive behavior toward community benefit.

I submit that Opportunity Zones mark the near-complete transition to privatized federal community and economic development policy. I do not mean to set up that involving the private sector in community and economic is entirely negative—there are some real advantages. But a heavy reliance on the private sector to accomplish the public agenda introduces a new set of pitfalls and shortcomings, sometimes fundamental ones, to our policy objectives. There are opportunity costs to our Opportunity Zone spending.

What's promising about Opportunity Zones?

More than 10 million people with incomes below the poverty level, and more than 1.8 million who are unemployed, live in Opportunity Zones. Moreover, more than 21 million people of color reside in Zones. While some Zones should never have been eligible or selected, many show a real need for investment. By leveraging private actors, Opportunity Zones could become the nation's largest economic development program. Opportunity Zones will undoubtedly attract substantial capital into Zones in aggregate. And impact investors and other creative community developers will use this tool to bring benefits to some needy communities. Opportunity Zones have several compelling features, specifically that they:

- **Tap into a new investor pool**: Secretary Mnuchin estimates Zones could attract as much as $100 billion in private capital and could alter the landscape of the 8,764 designated communities.[2] Many of these potential investors could be drawn into distressed communities they have never before considered.
- **Can be used as a tool for mission-driven projects:** Under the right circumstances, Opportunity Zones will achieve positive community-driven outcomes. Some deals will revitalize severely

[2] See "Treasury Releases Proposed Regulations on Opportunity Zones Designed to Incentivize Investment in American Communities," press release, October 19, 2018, https://home.treasury.gov/news/press-releases/sm530.

distressed communities, finance burgeoning small businesses, and create new affordable and workforce housing.

- **Encourage a longer-term investment horizon:** While many factors are at play, investors often desire shorter time horizons for return than what developers and businesses are seeking. However, there are advantages for businesses in securing longer-term financing. Opportunity Zones provide an incentive for investors to place their capital gains in qualified businesses for ten years instead of the, say, five or seven years that they may otherwise prefer.

- **Incentivize equity investments:** Several federal programs encourage the provision of debt financing to businesses, but relatively few encourage the provision of equity financing.

Where do limitations, challenges, and inefficiencies exist?

- **Limited place-based targeting:** Roughly 56 percent of all census tracts in the country were eligible for designation as Opportunity Zones. Compared with eligible tracts that were not chosen, selected communities tended to have slightly lower median incomes, higher poverty rates, and higher unemployment rates, but little difference in existing capital flows.[3] But averages belie a tremendous diversity of Zones. For example, there are Opportunity Zones in Manhattan, downtown Brooklyn, and downtown Berkeley, where the median home value is more than $1 million. Yet, there is also a Zone in Youngstown, Ohio, where more than half of households live below the poverty level and the median home is worth $14,000.[4] While these are extremes, the incentive's lack of guardrails or intermediaries means capital may agglomerate disproportionately to the most economically robust Zones—as already occurs in the financial market more broadly. Moreover, the largest tax benefit in the incentive (permanent exclusion of new gains) is linked to asset appreciation: the more appreciation, the more capital gains taxes avoided.

- **Real estate will be the largest use case:** I expect real estate investments to be the clear winner over operating business investments due to relative risk, business and investment eligibility criteria, challenges with investor exits, and longer-term holding period incentives. Real estate will produce the best return in neighborhoods undergoing rapid change. This has implications for how successful the policy will be in creating jobs in disinvested urban and rural communities.

- **Lack of community input:** It is notable how little community input is required to access federal resources under this new incentive. The incentive is provided in return for equity investment in any qualified Opportunity Zone business that meets the geographic and business eligibility thresholds, is not classified as a "sin business," and fulfills the substantial improvement and other clauses. There are no stipulations in the incentive's structure for community voice or alignment with localized goals. No prioritization is given to projects and businesses that fill

[3] See Brett Theodos, Brady Meixell, and Carl Hedman, "Did States Maximize Their Opportunity Zone Selections? Analysis of the Opportunity Zone Designations" (Washington, DC: Urban Institute, 2018).

[4] Investment score and relevant socioeconomic data for all eligible and designated census tracts are available at https://www.urban.org/research/publication/did-states-maximize-their-opportunity-zone-selections.

specified capital gaps and meet designated community needs. Moreover, communities have no recourse to mitigate harm. The incentive could go toward projects or businesses that directly counteract community priorities (e.g., pricing out current residents and small businesses or contaminating the environment).

- **Lack of use-based requirements:** Eligibility requirements are minimal compared with other federal community development tools. For example, there are no requirements (as with the low-income housing tax credit) that new apartments be rented to low- or moderate-income residents; no requirements (as with the Small Business Administration's 7(a) and 504 loan guarantee programs) that federally backed investment occur only when fully private-market financing is unavailable; and no requirements (as with the New Markets Tax Credit) that investors establish an oversight board of community development experts and representatives. Not all projects will be harmful to communities, not even the majority. But some proportion will be, and the federal government has not sufficiently narrowed the eligible uses of this incentive to activities that will directly benefit low- and moderate-income residents or contribute to broader economic development in truly disinvested communities.

- **Lack of reporting requirements:** As currently proposed, IRS regulations and Form 8996 are inadequate to help community members, investors, state and local public officials, and even Congress understand this program. The draft form requires reporting at the Opportunity Fund-level, but we need transaction-level detail. Nonburdensome reporting on the who, what, when, where, and how much of any Opportunity Zone investment is crucial for judging the incentive's costs and benefits and for ensuring accountability over taxpayer dollars.[5] Much of the data about other federal programs and incentives (e.g., New Markets Tax Credits, Community Development Block Grants, community development financial institution lending, Community Reinvestment Act lending, Small Business Administration–backed loans and investments, and Economic Development Administration grants) are captured and made available. While other community development programs have sometimes required more intensive impact reporting—for example, going back years later to do original data collection about the number of jobs created for every project—I think Opportunity Zones should be treated differently. The program's effects can be sufficiently well observed and understood as long as basic transaction inventory reporting is required—and this information is shared publicly. This imposes less burden on investors than extensive original data collection. The set of facts and figures required to monitor Opportunity Zones is the very set Opportunity Funds will be tracking and collecting to analyze their own investments. These transaction-level data should be reported annually as part of an Opportunity Fund's certification process. But in addition to collecting data, The Department of the Treasury (Treasury) and the IRS must share this information widely. Without full understanding of the projects supported by this incentive, little can be done to properly assess and monitor its results for communities. With access to these data, waste,

[5] For a detailed list of recommended reporting metrics see Brett Theodos, and Brady Meixell, "https://www.urban.org/research/publication/public-comment-us-treasurys-request-information-data-collection-and-tracking-qualified-opportunity-zones" (Washington, DC: Urban Institute, submitted to the Department of the Treasury, May 30, 2019).

fraud, and abuse can be more actively reduced. A compact series of reporting requirements can satisfy multiple functions and stakeholders in one step.

Where Congress can act

The question of whether to extend the Opportunity Zone incentive will be before Congress in coming years. This decision will present an occasion to redefine the incentive in ways that ensure incentivized investments bring clearer benefit to communities. The following changes warrant consideration:

- **Remove all contiguous tracts as well as low-income tracts that no longer qualify as such**: Opportunity Zones that did not meet the low-income community threshold, but were eligible because they bordered low-income communities, are by definition not the communities in greatest need. In addition, Census tracts that, with updates to the Census Bureau's American Community Survey, no longer qualify as low-income communities, should also lose their status as Opportunity Zones. These tracts should be phased out of the Opportunity Zone incentive now for any projects not yet initiated. We need not wait until 2026 to encourage a greater flow of financing to truly disinvested and high poverty Zones.

- **More narrowly restrict qualifying Opportunity Zone investments:** Particularly for real estate investments, 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.

- **CDFI priority:** Any investment into a CDFI-controlled vehicle should be given preferential treatment. CDFIs are lenders and investors vetted for their track record of and capacity for mission-based financing.

- **Only allow investments passing a "but-for" test:** Many of the early Opportunity Zone deals finance projects I have reviewed were already being finalized before the parties elected to add Opportunity Zone financing, or their sponsors report they would have occurred in the same form absent this new legislation. This means the federal government is subsidizing investments that do not need the help to go ahead. Some other federal community and economic development programs have "but for" or "substitution" tests embedded. By restricting the incentive to projects that could only proceed with the additional help of the incentive, the federal government could reduce the total cost of the incentive and reserve federal tax dollars to incentivize new development that would not have been generated by the private market alone.

- **Restructure the tax benefits:** Opportunity Zones provide investors three distinct tax benefits: temporary deferral of invested capital gains, basis step-up of invested capital gains, and permanent exclusion of taxable income on new gains. The first two incentives are more certain, and thus can influence investor behavior more predictably, spurring the new development the law intends to create. These incentives should be maintained and possibly expanded by making them ongoing (not sun-setting in 2026) or deepening the step-up in basis—but with strict conditions. The step-ups could be further targeted and differentiated by the economic distress of Zones. (For example, the step-up in basis might be 0 percent for the best-off Zones, 5 percent for the next tranche, then 10 percent, then 15 percent, then 20 percent for the most distressed Zones.) The permanent exclusion of future gains will likely be the most expensive provision of this legislation but is also the least certain from an investor standpoint and rewards speculation. Congress should consider eliminating it.

- **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 Opportunity Zone investments made as a condition of receiving a federal tax benefit.

Where the Administration can act

Treasury has already released proposed regulations for Opportunity Zones. In the revision process, they should consider taking the following actions.

- **Make this tool more like a "program," not merely an "incentive":** An agency or subagency 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 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.

- **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 currently advanced by Treasury. As part of this process, Opportunity Funds should be required to demonstrate an intention to and plausible mechanism for investing in projects that yield true community benefit—and to adhere to disclosure and reporting requirements and community engagement processes.

- **Require transaction reporting**: 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. Reporting should be required through a mechanism separate from a tax form. (Greater difficulties arise around public reporting of data collected via tax forms.)

If Treasury fails to take these steps, Congress should revise the legislation to mandate the changes.

In conclusion

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