What It Will Take for Opportunity Zones to Create Real Opportunity in America's Economically Distressed Areas

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The Opportunity Zone program, created by the federal Tax Cuts and Jobs Act of 2017, is the nation's latest public policy attempt to spur economic development in economically distressed areas by encouraging private investment.[1] Under the program, an individual or organization can defer paying federal income tax on the capital gain from the sale of an asset by investing that gain in a Qualified Opportunity Fund (QOF). QOFs are required to invest at least 90 percent of their assets in businesses or real estate located in economically distressed areas that are designated as Opportunity Zones. If the investor holds the investment for a long enough period of time, the capital gains tax is reduced or even eliminated.[2]

The federal law required each state's governor to designate Opportunity Zones from among the high-poverty or low-income census tracts in the state. All governors made their designations in 2018. These designations cannot be changed during the life of the program.

Will Opportunity Zones create real opportunities for the residents of distressed areas? It's too soon to tell. The record of similar programs in the past (such as Enterprise Zones and Empowerment Zones) is at best mixed.[3] However, Opportunity Zones have far fewer restrictions than those programs. That may unleash more capital, which could lead to more development. But the Opportunity Zone program lacks critical safeguards that would ensure that investments go where they are most needed, make economic sense for and meet the needs of local communities, and can be monitored and evaluated.

Because the federal law doesn't require such safeguards, it's up to social impact investors to abide by them voluntarily. The responsibility falls on local governments to encourage and, where possible, provide incentives for investors to do so. That leaves community organizations, anchor institutions, foundations, and other organizations with a stake in the economic progress of low-income communities to establish standards and persuade investors to follow them. Four fundamental principles that embody the necessary safeguards should guide Opportunity Zone investments to ensure that they benefit the existing residents of distressed areas.

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One.
Focus on places in need.

A census tract was eligible to be designated as an Opportunity Zone if it had either a poverty rate of at least 20 percent, a median family income not more than 80 percent of the higher of the metropolitan or state median (for tracts located in metropolitan areas), or (for nonmetropolitan tracts) a median family income not more than 80 percent of the state median. (Some tracts in rural counties could qualify based on slightly higher income limits if they were experiencing outmigration.) Governors could also designate a limited number of tracts contiguous to those otherwise eligible if their median family income was no higher than 125 percent of that of a contiguous eligible tract.

In general, states chose relatively low-income areas as Opportunity Zones, although they didn't target the most distressed areas that were eligible. However, they were allowed to (and in some cases did) choose places that presented good investment opportunities but for which the program is not appropriate:

- University districts, even if their high poverty rates or low incomes were due to their large student populations.[4]
- Locations of state prisons, even if inmate populations accounted for the bulk of their poverty and low-income populations.[5]
- Places that don't lack investment despite their high poverty rates or low incomes.[6]
- Isolated pockets of poverty that are not surrounded by larger high-poverty areas.[7]
- Tracts where low-income residents are being displaced or are at risk of being displaced by gentrification (and where ill-chosen investments have the potential to accelerate gentrification and displacement).[8]
- Other places where development is likely to happen without the Opportunity Zone tax incentive.[9]

It is possible to identify the zones with these characteristics. State and local governments, community organizations, and foundations should encourage QOFs to avoid such places, although there should be exceptions for investments that primarily benefit the zones' current residents, such as affordable housing in expensive, rapidly gentrifying cities.

In addition, impact-oriented investors should give special consideration to zones that exhibit other indicators of socioeconomic disadvantage in addition to those required for zone designation, such as high child poverty rates, low educational attainment, large minority populations, and a lack of existing business activity.[10] Although not all zones with all these characteristics are disadvantaged and not all zones that lack them are unworthy of tax-subsidized investment, considering these characteristics will make it possible for more investment to flow to places in need.

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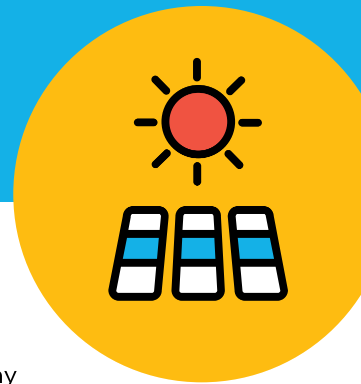
Two.

Focus on non-real estate business investments that make economic sense for low-income communities.



Much of the discussion of Opportunity Zones in the news media and the investment community focuses on real estate.[11] But investment in real estate alone, especially residential real estate, has rarely developed low-income communities. The investments that will make the most difference for the current residents of those communities are investments in new or existing non-real estate businesses.

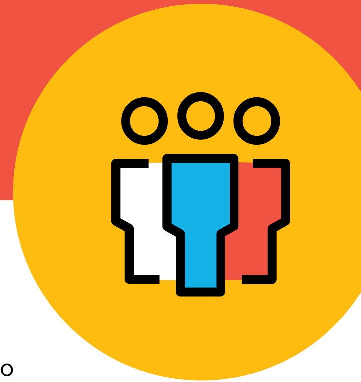
To choose the kinds of businesses that make the most economic sense for a community, investors should begin with the industry clusters that are the economic foundations of the community. Industry clusters—closely related and interconnected businesses that operate within a specific geography and benefit from their geographic proximity—reflect the economic strengths of a geographic area.[12] The strongest clusters in an area (those whose share of the area's employment is highest compared to their share of nationwide employment) are the ones on which the community's economy currently depends the most. One strategy for targeting investments is to prioritize investment in the clusters that are strongest in an Opportunity Zone or the larger high-poverty areas that surround the zones that are the best candidates for investment. That strategy is one of reinforcing existing economic strengths. Another approach is to target clusters that are not currently strong but are emerging in the area. A third option is to pursue a strategy of "related diversification"—investing in clusters that are not currently strong but are related to strong clusters by common technologies, workforce skill needs, supply chains, or consumer preferences. A final option is to pursue "unrelated diversification"—investment in firms whose clusters are not related to any current or emerging economic strengths. This is a risky strategy to pursue because it doesn't draw on an area's current strengths in any way, but it can sometimes work, for example, if it is based on a technology developed by a local university or involves suppliers or potential suppliers to a large company that is moving into the area or a large-scale government investment.

To succeed, business investments often need complementary investments in such things as workforce skills, infrastructure, the technological capacities of supplier firms, or the financial literacy of potential customers. With the partial exception of infrastructure investments, QOFs cannot receive tax advantages from making these complementary investments, many of which are better undertaken by governments or nonprofit organizations than by private companies.

Although Opportunity Zone investments should go primarily to non-real estate businesses, there is a limited role for real estate developers to take advantage of the zones' benefits. QOFs should invest in commercial real estate that directly supports new or existing businesses, for example, by building, renovating, or preparing sites for commercial or industrial buildings. Residential real estate investment, though, should generally be limited to affordable housing, especially in areas that are experiencing or are poised for rapid price appreciation.

Three.

Guide investments to meet public and community priorities.



Local governments, community organizations and residents, and other organizations with a public mission have no legally mandated role in the Opportunity Zone program. Nevertheless, there are many opportunities for them to influence the kinds of investments that take place in the zones.[13]

Local governments can use a combination of carrots and sticks to influence QOF investments in their jurisdictions. On the positive side, they can, put together Opportunity Zone "prospectuses" that give an economic overview of their jurisdictions and Opportunity Zones and highlight investment opportunities in the zones.[14] A number of cities, including Stockton, California, and Louisville, Kentucky, have already done this.[15] The prospectuses are marketing documents but they can also steer investors toward the investments that local governments favor. Local governments and foundations can also encourage investment in QOFs that abide by the principles described in this policy brief by providing principal-protection guarantees, direct investments, or first loss capital to these funds. Although governments and foundations can't receive any tax benefits, they can use their roles in these funds to favor projects that meet their priorities.

Local governments also have tools at their disposal to help them discourage or even prohibit Opportunity Zone investments that don't meet their priorities. They can apply their laws—including zoning, permitting, business licensing, local hiring, wage regulation, disadvantaged business preference, and business tax incentive laws—to Opportunity Zone investments, just as they can to any other development projects. (Boulder, Colorado, is already taking this approach.[16]) If a QOF proposes a project for which it is seeking a benefit (such as a local tax incentive) or a discretionary change in the law (such as a zoning variance), local officials have legal leverage to reshape or block developments that they find undesirable and to require the Fund to make the kinds of disclosures (described below) that would inform the public about proposed investments. Even in cases where they don't have that leverage, they can use their power of public persuasion to accomplish these goals.

The people most directly affected by Opportunity Zone investments—the residents of the zones—should have a prominent voice in influencing investments in their zones. Community organizations should weigh in on proposed investments and organize residents to support or oppose them. Local governments should amplify community voices by creating Opportunity Zone advisory councils.[17] The councils should include residents of the zones and representatives of community organizations that are active in the zones. Local officials should consult the councils in developing their positions on investments in the zones.

Foundations, anchor institutions, and other organizations that care about the economic progress of low-income communities can also help push QOF investments toward meeting public and community priorities. They can do so by investing in or providing downside protection for QOFs that have committed to specific social impact covenants, as the Kresge Foundation has done with two Funds.[18] They can also use their own powers of public persuasion to establish norms that the best impact investors would follow and that could have some influence on other investors as well. For example, if a number of foundations and anchor institutions, nationally or in particular states or regions, were to endorse the principles advocated here, they could create informal but powerful expectations about what Opportunity Zones should be.

Four.

Build in transparency and accountability.

The Tax Cuts and Jobs Act doesn't require any kind of public disclosure or evaluation of QOFs' investments. (An early draft of the legislation required this but the law as enacted does not.) Without transparency and accountability, there is no way for anyone other than the individual investors to know what kinds of investments are being made in the zones and by whom, and no way to evaluate whether the zones are serving their intended purpose.

In each year of their operation, QOFs should publicly disclose the identities of their investors; the locations, recipients, and amounts of their investments; key performance indicators such as the number of jobs created and revenues generated by the businesses in which they invest; and the aggregate tax savings received by their investors. This would enable local governments, community organizations, and residents of the zones to know what kinds of investments are being made in their neighborhoods, who is making them, and what tax benefits investors are receiving. That information is essential if local governments and communities are going to attempt to influence Opportunity Zone investments.

Disclosure of jobs created and revenues generated by businesses receiving QOF investments is also critical for evaluating the Opportunity Zone program. The job and revenue performance of those businesses can be compared with that of similar businesses located in comparable census tracts that were eligible to be designated as Opportunity Zones but were not designated. Such a comparison would provide a rough indication of whether the zones were contributing to business growth.

QOFs should also disclose other information about the businesses in which they invest, including average and median wages, availability of health and retirement benefits, employment of people who live in low-income neighborhoods, employment of people with less than a bachelor's degree, employment of women and people of color, and the presence of female entrepreneurs and entrepreneurs of color, to name a few. Although these characteristics of Opportunity Zone businesses cannot readily be compared with those of businesses located in eligible non-designated tracts, they can be used to gauge whether businesses receiving Opportunity Zone investments are meeting or exceeding national or local benchmarks.[19]

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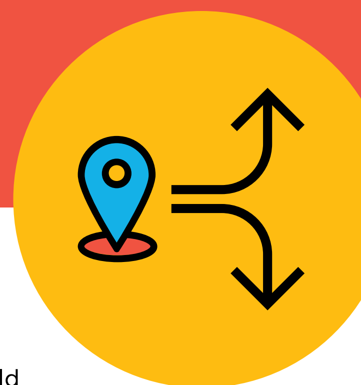
Putting It All Together



Opportunity Zones should be seen as part of a broader set of policies to attack the problem of concentrated poverty. They should complement existing place-based policies, such as the New Markets Tax Credit and Low-Income Housing Tax Credit, as well as place-neutral antipoverty policies, such as policies to improve workers' skills and the quality of low-wage jobs.

Opportunity Zones, even if used in the best possible way, are unlikely to benefit the very poorest areas. A capital gains tax incentive, even one as generous as that of the Opportunity Zone program, simply won't be enough to make investments in those places profitable. Those places need a more direct government role. For the most part, investments that follow the four principles advocated in this policy brief will favor zones that are not already developing rapidly or poised to do so, but not so poor that the tax incentive will be insufficient.

Nevertheless, if a critical mass of impact investors, local governments, and other relevant organizations were to follow those four fundamental principles, the Opportunity Zone program could help create real opportunity for the residents of many of America's economically distressed communities:

- Investors would invest in places with genuine needs—not necessarily the most distressed areas, but not areas that would develop without the aid of the tax inventive.
- They would invest mainly in non-real estate businesses and would do so in ways that made economic sense for the communities in which they invested, catalyzing further development as part of a well-grounded economic development strategy.
- Local governments, community residents and organizations, and other relevant organizations would ensure that investments met public and community priorities.
- Robust transparency and accountability requirements would help them do so and would also make it possible to evaluate the Opportunity Zone program. Congress would use the evaluation results to decide the program's future.

That's the best-case scenario—the "high road" for Opportunity Zones. Unfortunately, there's also a "low road," a scenario in which:

- Investments occur mainly in places that would develop on their own.
- Zones facilitate widespread gentrification and displacement of low-income residents.
- Investments make economic sense for private investors but not necessarily for local communities.
- There is no public or community influence over investments.
- Only investors know anything about investment outcomes (probably only about financial outcomes).
- There is no way to know whether the program is succeeding.

The more that investors, local governments, and other organizations follow the principles described here, the more likely it is that the high-road scenario will occur. That's what it will take for Opportunity Zones to live up to their promise.

Endnotes

1 The requirements of the Opportunity Zone program are found in sec. 13823 of the Tax Cuts and Jobs Act of 2017, Public Law 115-97, 131 Stat. 2054, available at https://www.congress.gov/115/plaws/publ97/PLAW-115publ97.pdf.

2 Describing this as "very favorable treatment," Adam Looney estimates that "[i]ndividuals in a high-tax state and with short-term capital gains can avoid $7.50 in taxes for each $100 they invest, even before considering any return on their Zone investments." Adam Looney, "Will Opportunity Zones Help Distressed Residents or Be a Tax Cut for Gentrification?" Brookings Institution *Up Front* blog, February 26, 2018, https://www.brookings.edu/blog/up-front/2018/02/26/will-opportunity-zones-help-distressed-residents-or-be-a-tax-cut-for-gentrification.

3 For a review of the evidence on the impacts of such programs, see David Neumark and Helen Simpson, "Do Place-Based Policies Matter?" *Federal Reserve Bank of San Francisco Economic Letter* 2015-07, March 2, 2015.

4 Hilary Gelfond and Adam Looney list 33 Opportunity Zones that include college campuses and have populations consisting of at least 85 percent college students. Among the well-known colleges included in Opportunity Zones are the University of Southern California, the University of Maryland, the University of Illinois at Urbana-Champaign, and Penn State University. Hilary Gelfond and Adam Looney, *Learning from Opportunity Zones: How to Improve Place-Based Policies* (Washington: Brookings Institution, 2018), p. 9.

5 Gelfond and Looney note that one of Florida's Opportunity Zones is a correctional facility. Gelfond and Looney, *loc. cit.*

6 Brett Theodos and co-authors rank all tracts that were eligible to be designated as Opportunity Zones on their relative amounts of capital investment and find that "[t]he actual Opportunity Zone designations reflect only minimal targeting of the program toward disadvantaged communities with lesser access to capital relative to all eligible tracts." Brett Theodos, Brady Meixell, and Carl Hedman, *Did States Maximize Their Opportunity Zone Selections?* (Washington: Urban Institute, 2018), p. 3.

7 Timothy Bartik has criticized the Opportunity Zone program for this reason, among others. See John Gallagher, "Experts Doubt New Tax Break Will Help Detroit As Advertised, Detroit Free Press, February 13, 2019, https://www.freep.com/story/money/business/john-gallagher/2019/02/13/detroit-opportunity-zones-tax-incentives-gentrification/2846284002. In some places, such as Chicago, many Opportunity Zones appear to be located in larger high-poverty areas. See Brett Theodos and Brady Meixell, *How Chicago and Cook County Can Leverage Opportunity Zones for Community Benefit* (Washington: Urban Institute, 2019), p. 5.

8 Theodos and co-authors identify Opportunity Zones that rank well above the national average on their 2000-2016 change in an index of four characteristics that may indicate gentrification: the share of residents with at least a bachelor's degree, median family income, the share of non-Hispanic white residents, and average housing cost burden. Theodos, Meixell, and Hedman, op. cit., pp. 11-12.

9 See Gallagher, *op. cit.*

10 Gelfond and Looney have ranked Opportunity Zones on these criteria, among others. Gelfond and Looney, *op. cit.*, pp. 3-5.

11 See, e.g., Jim Tankersley, "Investors Eagerly Await Trump Rules on Opportunity Zones," *New York Times*, March 17, 2019, https://www.nytimes.com/2019/03/17/us/politics/opportunity-zones.html.

12 See Joseph Cortright, *Making Sense of Clusters: Regional Competitiveness and Economic Development* (Washington: Brookings Institution, 2006).

13 On the need for such organizations to help shape Opportunity Zone outcomes, see Rachel Barker and Alan Berube, "Opportunity Zones and Shared Prosperity: Emerging Principles from Cleveland," Brookings Institution *The Avenue* blog, September 19, 2018, https://www.brookings.edu/blog/the-avenue/2018/09/19/opportunity-zones-and-shared-prosperity-emerging-principles-from-cleveland.

14 Bruce Katz and Evan Weiss, *From Transactions to Transformation: How Cities Can Maximize Opportunity Zones* (Philadelphia: Nowak Metro Finance Lab, Drexel University, 2018), pp. 12-13.

15 See City of Stockton, Opportunity Zones Prospectus, Stockton, California: A Guide to Finding the Right Investment for You (Stockton, CA: City of Stockton, 2019), http://www.stocktonca.gov/files/StocktonOZProspectus.pdf; New Localism Advisors in collaboration with the City of Louisville, Louisville Opportunity Zone Prospectus: A Platform for Action (n.p., 2018), https://louisvilleky.gov/sites/default/files/louisville_forward/louisville_prospectus_version_13_11.5.2018.pdf.

16 See the City of Boulder's Opportunity Zone webpage, https://bouldercolorado.gov/business/opportunity-zone-program.

17 For a similar proposal, see Wendy Patton and Michael Leonard, *Assessing Opportunity Zones in Ohio* (Cleveland: Policy Matters Ohio, 2018), pp. 12-13.

18 Kresge Foundation, "Kresge Foundation commits $22M to back Arctaris, Community Capital Management Opportunity Zone Funds," March 18, 2019, https://kresge.org/news/kresge-foundation-commits-22m-back-arctaris-community-capital-management-opportunity-zone-funds.

19 The Opportunity Zones Reporting Framework, developed by the U.S. Impact Investing Alliance and the Beeck Center at Georgetown University, provides an even more comprehensive list of suggested metrics for individual OOFs. These could easily be integrated into the transparency and accountability recommendations presented here. See U.S. Impact Investing Alliance and the Beeck Center, "Prioritizing and Achieving Impact in Opportunity Zones" (n.p., 2019), https://static1.squarespace.com/static/5c5484d70b77bd4a9a0e8c34/t/5c61f945fa0d605af5448daf/1549924682936/Opportunity+Zones+Reporting+Framework+-+February+2019.pdf.