

Learning from Opportunity Zones: How to improve place-based policies

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Contents

Introduction 1

1. Target incentives towards the right places1

2. Use Appropriate Financing, Monitor Compliance, and Mandate Transparency 10

3. Apply Adequate Guardrails.....12

4. Evaluate.....12

Conclusion.....13

References14

Congress created Opportunity Zones to funnel investment to economically distressed neighborhoods in its 2017 tax bill. Opportunity Zones offer favorable capital gains treatment for taxpayers with unrealized gains who invest in designated low-income communities (LICs). While the program was intended to target distressed areas, eligibility was broad—57 percent of all neighborhoods in America qualified—and not all were truly distressed. State governments, which had broad discretion to select from qualifying areas, faced a conflict between selecting deeply distressed areas versus already improving or gentrifying areas that were more likely to provide tax benefits to qualifying investors.

We now have a complete list of all areas designated as Opportunity Zones.¹ Some are areas clearly in distress. Others, not so much. That's a problem for the program's impact; poor geographic targeting reduces the impact of the program and limits the benefits that accrue to poor residents. While federal criteria helped direct state's choices to relatively disadvantaged places, in some cases states sought loopholes or otherwise picked places that did not need the help or were already on their way to success. And regulations released in October 2018 allow as much as 30 percent of Opportunity Zone funds to be invested outside of qualified Zones.

The design of the program's tax subsidy is also likely to constrain the benefits to poor residents. Eligibility for Opportunity Zone tax benefits is limited to investors with pre-existing capital gains and those who expect to face future capital gains taxes.² That means few Americans will qualify. According to the Federal Reserve Board, only 18 percent of households hold financial assets with an unrealized capital gain, and the median capital gain among those who do is \$5,000 (Survey of Consumer Finances 2016, Table 10). And, in 2018, Tax Policy Center estimates suggest that only 6.5 percent of Americans will pay any tax on capital gains.³ The new archipelago of domestic tax havens will surely attract investment from those investors who do hold substantial sums of unrealized gains. And new regulators allow them considerable flexibility over how or when they can be used. Few federal policies feature such large, uncapped tax subsidies with so few limits on how those subsidies can be used.

How can policymakers make sure future place-based policies really go to investments in communities and people that need it? This report offers four suggestions to improve place-based programs, motivated by the economic literature, experience with previous place-based policies, and early evidence from Opportunity Zone selections:

- Target the right places and use better data to do it.
- Use appropriate financing, monitor compliance, and mandate transparency.
- Put strong guardrails on the use of federal subsidies.
- Rigorously evaluate programs to see if they achieve their goals.

1. Target incentives towards the right places

It seems obvious, but if one is trying to help people in distressed areas, one needs to target places that are truly distressed. That's harder than one might think because the necessary data and defining criteria are inadequate. In the case of opportunity zones, the data used to identify places worthy of federal subsidies after 2018 dates back as far as 2011, and the primary measure of economic distress—the official poverty rate—is a relatively poor measure of economic conditions and opportunities.

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1. For earlier analyses of Opportunity Zones, see Looney (2018a, 2018b).

2. §1400Z-2(e)(1)(B).

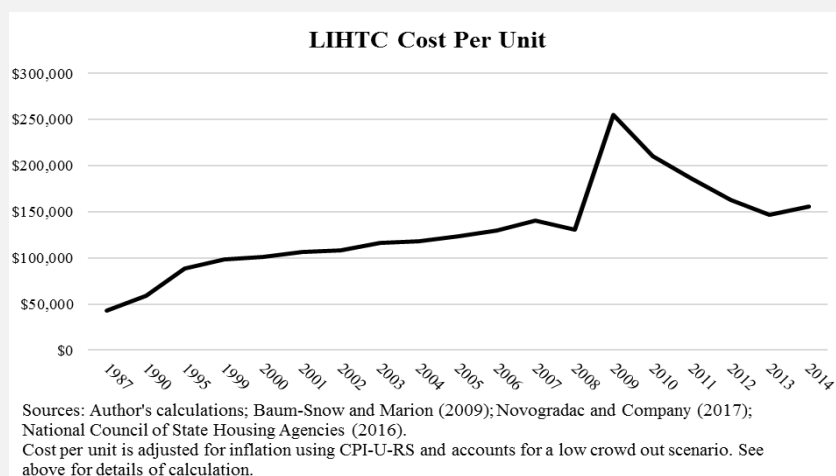
3. Tax Policy Center Table T18-0052

A second, less obvious, reason why targeting matters is that the evidence suggests the beneficial effects of place-based investments depend on the depth of distress in the neighborhood. For instance, Rebecca Diamond and Tim McQuade suggest that Low Income Housing Tax Credit (LIHTC) investments have positive spillovers—they improve property values, reduce crime, and create more economically diverse neighborhoods—but only in neighborhoods where the median income is very low (below \$26,000 in their analysis). There seem to be no such positive spillovers in higher-income neighborhoods. In fact, they find that LIHTC development in higher-income neighborhoods (those with median incomes above \$54,000) lead to declines in housing prices.⁴ Hence, the places that benefit most are those in deepest need.

Box 1: Targeting, Crowd out, and Cost Effectiveness: The Low-Income Housing Tax Credit's cost per new unit

In 2014, the total first-year LIHTC allocation was \$773.5 million, which subsidized 58,317 units, or about \$13,300 per unit (\$773.5 million/58,317). Credits are available for 10 years, so the total undiscounted per-unit cost is \$135,000. Using Treasury yield curve, the Net Present Value (NPV) of this per-unit cost is about \$123,000. However, these credits accrue to all qualifying units, including units that would have been built anyway. This substitution of privately-financed units for publically-financed units is called “crowd out.” Baum-Snow and Marion (2009) estimate that for every five units that benefit from LIHTC 1 would have been built anyway. (In gentrifying areas, Baum-Snow and Marion (2009) estimate that the rate of crowd out is much higher.) As a result of crowd out, the cost per unit is significantly higher since some of the units would have been built anyways. Thus, the true cost per new unit is closer to \$154,000 (or higher in gentrifying areas).

The chart below presents the average cost per new unit of affordable housing paid for by LIHTC (adjusted for inflation using the CPI-U-RS) The LIHTC cost per unit has increased substantially over time, with a peak during the Great Recession, when legislative changes enhanced its value to attract investors and stimulate activity.



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4. Diamond and McQuade (2017).

Finally, targeting is also important for maximizing cost effectiveness. A major drag on the cost effectiveness of place-based policies is crowd-out—when the government pays a subsidy to a building or an investment that would have been made anyway, and thus “crowds out” private investment with public funds. Consider again LIHTC—the best estimates suggest that on average for every five low-income units that receive the credit, one would have been built anyway (Baum-Snow and Marion, 2009). That means the federal government’s cost to produce each *new* unit is actually 25 percent higher—and that the average cost to the federal government from each new unit of affordable housing in 2014 cost about \$156,000. (Box 1 explains how we derive this estimate.)

However, the same research suggests that there is no crowd out in neighborhoods where housing prices are flat or falling (specifically, places in the bottom third of housing price appreciation)—in short, places that are not gentrifying. So targeting stagnant neighborhoods really increases the bang for the buck. In the case of Opportunity Zones, as the data below shows, many states elected to use the program in high price appreciation areas (defined as tracts above the 75th percentile of price appreciation within each state)—a boon to investors hoping to reap the tax benefits on their capital gains, but driving up the cost and cost-effectiveness of the program.

Hence, better targeting is one way to improve the efficacy of place-based policies. For provisions like LIHTC, for instance, better targeting would do more to increase the supply of housing at the same cost. The same is likely true for Opportunity Zones, which raises the question—how well were they targeted?

Distress Levels of Opportunity Zone Tracts

The Opportunity Zone program is not very targeted to deeply distressed areas. Nationwide, 45 percent of all neighborhoods qualified to be selected based on their low-income status and a total of 57 percent qualified considering other criteria.⁵ That gave states broad authority to choose, especially in states with high average poverty rates. Some picked well; others did not. The good news is that on average, states selected relatively disadvantaged areas for their Opportunity Zones. The average poverty rate of selected zones was 29 percent (in 2016), compared to an average neighborhood poverty rate nationwide of 15 percent, and an average rate within qualifying low-income communities of 25 percent. Across a range of indicators like child poverty and educational attainment, states’ selections are, on average, more disadvantaged than the low-income tracts they did not select, and selections had larger minority populations (Table 1). Based on new measures of economic opportunity—how far up the economic ladder low-income children born in the early 1980s had climbed as adults—Opportunity Zones generally targeted low-opportunity neighborhoods.

That said, 24 percent of selections were areas with low poverty rates below the 20 percent threshold (in 2016) and 11 percent had poverty rates below the national average (15 percent). And some states selected zones that were, on average, better off on many dimensions than the low-income areas they skipped over.

To summarize states’ choices, we formed an index of economic distress based on poverty rates (adjusted for the number of university-student residents, who are misleadingly often counted as living in poverty), child poverty rates, educational attainment (the fraction with at least some college education), home prices, and family income for each tract within each state.⁶ The index ranks each state’s tracts from least to most distressed (0 to 100).

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5. IRS Notice 2018-48. The share of tracts eligible to be designated as an OZ exceeds the share designated as low-income because census tracts adjacent to LIC tracts may also qualify if the median family income of the tract does not exceed 125 percent of the contiguous LIC Opportunity Zone. States are limited in the number of Opportunity Zones they can designate.

6. Specifically, within each state we summarized each measure using a normalized z-score (top coded at an absolute value of 2) and formed the index based on the mean z-score across all 5 factors. To form the adjusted poverty rate, we assume half of enrolled college or graduate students are recorded as living in poverty. In general, the broad results are not sensitive to the modest changes in the construction of the index.

Table 1. Characteristics of Low-Income Communities Designated Opportunity Zones

	Distress Index		Poverty Rate		Child Poverty		Percent with Some College		Median Home Value		Change in Income		High Price Appreciation	
	Not Se- lected	Se- lected	Not Se- lected	Se- lected	Not Se- lected	Se- lected	Not Se- lected	Se- lected	Not Se- lected	Selected	Not Se- lected	Se- lected	Not Se- lected	Se- lected
Alabama	0.65	0.67	23%	26%	38%	43%	45%	48%	98,159	103,146	3%	4%	28%	23%
Alaska	0.75	0.74	15%	14%	25%	23%	54%	54%	183,575	174,829	-1%	10%	15%	24%
Arizona	0.74	0.76	24%	27%	38%	41%	47%	48%	116,191	112,496	3%	3%	26%	18%
Arkansas	0.64	0.72	22%	26%	37%	40%	45%	43%	94,159	90,520	3%	11%	23%	23%
California	0.71	0.85	18%	29%	30%	43%	47%	39%	313,927	255,223	4%	4%	26%	25%
Colorado	0.75	0.81	16%	18%	26%	30%	56%	54%	196,735	173,701	9%	7%	28%	24%
Connecticut	0.78	0.83	15%	21%	27%	34%	47%	45%	186,865	182,738	2%	7%	14%	18%
Delaware	0.74	0.80	14%	20%	26%	35%	48%	46%	175,327	164,312	-2%	6%	20%	26%
DC	0.67	0.78	19%	26%	30%	39%	57%	48%	392,672	298,002	15%	8%	24%	14%
Florida	0.73	0.84	20%	28%	34%	43%	48%	40%	123,725	106,290	2%	4%	19%	17%
Georgia	0.63	0.87	20%	34%	34%	54%	49%	39%	117,173	86,475	3%	2%	20%	28%
Hawaii	0.76	0.84	15%	16%	25%	25%	59%	50%	386,894	385,953	7%	10%	17%	10%
Idaho	0.73	0.72	18%	18%	30%	29%	58%	54%	137,080	144,103	6%	16%	25%	36%
Illinois	0.69	0.85	17%	29%	29%	46%	50%	45%	144,590	110,815	4%	4%	21%	19%
Indiana	0.71	0.73	21%	23%	35%	38%	46%	46%	90,857	96,712	3%	8%	14%	25%
Iowa	0.72	0.81	16%	19%	25%	30%	54%	50%	110,099	90,887	8%	8%	13%	30%
Kansas	0.72	0.73	18%	19%	29%	28%	52%	55%	90,352	90,558	5%	6%	21%	29%
Kentucky	0.67	0.74	23%	27%	36%	41%	43%	41%	97,342	91,387	6%	6%	23%	30%
Louisiana	0.64	0.72	24%	29%	39%	44%	44%	41%	119,972	108,810	2%	4%	22%	29%
Maine	0.73	0.73	18%	17%	28%	31%	51%	53%	144,252	130,884	3%	9%	27%	19%
Maryland	0.72	0.76	11%	15%	21%	26%	52%	51%	206,241	188,386	3%	5%	19%	16%
Massachusetts	0.76	0.80	16%	19%	28%	30%	51%	49%	281,165	247,537	7%	7%	26%	19%
Michigan	0.73	0.73	24%	25%	38%	39%	50%	52%	81,090	79,717	4%	3%	13%	14%
Minnesota	0.71	0.84	13%	20%	23%	32%	59%	54%	152,895	135,919	7%	10%	19%	17%
Mississippi	0.63	0.56	26%	25%	42%	40%	46%	51%	85,360	103,535	3%	5%	24%	40%
Missouri	0.69	0.75	19%	24%	32%	38%	48%	48%	102,424	97,562	4%	5%	22%	30%
Montana	0.70	0.80	19%	22%	29%	34%	59%	56%	169,550	143,120	7%	4%	29%	23%
Nebraska	0.76	0.79	16%	20%	28%	30%	54%	51%	101,524	95,024	4%	6%	17%	20%
Nevada	0.77	0.84	21%	27%	35%	41%	43%	39%	118,765	116,139	-1%	-3%	21%	35%
New Hampshire	0.77	0.81	10%	12%	18%	23%	54%	52%	183,045	176,669	5%	5%	23%	12%
New Jersey	0.78	0.83	17%	21%	29%	34%	45%	41%	235,020	247,926	1%	3%	19%	27%
New Mexico	0.70	0.68	25%	24%	39%	39%	49%	49%	123,810	125,632	2%	3%	27%	26%
New York	0.72	0.79	21%	26%	33%	39%	48%	46%	368,780	347,986	6%	10%	29%	34%
North Carolina	0.69	0.76	20%	24%	34%	39%	51%	48%	123,475	116,526	4%	5%	27%	27%
North Dakota	0.69	0.84	12%	19%	22%	26%	65%	57%	145,218	100,147	-4%	22%	4%	12%
Ohio	0.71	0.76	23%	27%	38%	42%	46%	44%	90,272	89,763	3%	9%	17%	21%
Oklahoma	0.72	0.74	22%	23%	35%	36%	47%	47%	88,751	84,645	5%	4%	21%	28%
Oregon	0.73	0.73	19%	20%	30%	31%	58%	59%	201,753	200,877	8%	9%	17%	24%
Pennsylvania	0.73	0.83	19%	27%	31%	42%	43%	42%	117,932	96,360	5%	8%	24%	29%
Rhode Island	0.81	0.78	22%	20%	36%	33%	44%	47%	173,888	191,836	6%	2%	7%	16%
South Carolina	0.69	0.76	21%	25%	36%	41%	46%	44%	107,089	98,390	5%	9%	26%	26%
South Dakota	0.76	0.74	21%	21%	32%	32%	53%	54%	97,910	101,731	4%	5%	12%	20%
Tennessee	0.70	0.75	22%	26%	37%	41%	43%	41%	109,084	110,239	3%	9%	23%	29%
Texas	0.70	0.75	22%	24%	36%	38%	43%	40%	104,107	93,252	7%	7%	19%	28%
Utah	0.77	0.85	15%	18%	26%	30%	60%	56%	173,597	158,179	4%	4%	14%	21%
Vermont	0.75	0.82	13%	16%	22%	27%	55%	55%	197,704	174,715	8%	6%	32%	23%
Virginia	0.71	0.75	14%	17%	24%	29%	52%	52%	180,665	181,733	4%	3%	24%	24%
Washington	0.74	0.80	16%	19%	26%	29%	57%	54%	203,211	197,210	6%	9%	19%	22%
West Virginia	0.68	0.58	21%	21%	34%	33%	39%	44%	90,609	116,251	2%	8%	27%	22%
Wisconsin	0.74	0.80	18%	23%	29%	36%	51%	51%	123,949	116,259	4%	6%	17%	25%
Wyoming	0.77	0.73	14%	14%	23%	24%	62%	61%	148,346	167,975	-5%	5%	31%	21%

Using the index, we ask whether states targeted their Zone designations to the most distressed neighborhoods—those ranked in the top 20 percent on the distress index within each state.⁷ As detailed in Figure 1, Georgia and Hawaii stand out for allocating the greatest share of their picks (both about 80 percent) to their most distressed neighborhoods. In these states, the average selected neighborhood ranked at the 87th and 84th percentile statewide for distress, respectively—more distressed than the eligible neighborhoods they passed over, which ranked in the 63rd and 76th percentiles (Table 1). Illinois, Iowa, Connecticut, Minnesota, Nevada, New Jersey, Vermont, California, and Pennsylvania are all close behind in allocating a large share of their picks to their most distressed areas.

Moreover, most states, on average, selected Zones that were more distressed, based on this index, than otherwise eligible low-income communities they did not select (Table 1). The largest gaps—indicating selection of especially distressed areas—were in Georgia, Illinois, North Dakota, California, Minnesota, DC, and Florida. In several other states—Oregon, Idaho, Alaska, Maine, Michigan, Alabama—the state’s selections were, on average, about the same as other LICs that were not selected.

Despite these successes, there was clearly opportunity for improvement even in states that selected relatively disadvantaged areas. States could have targeted more of their Zones to places in deeper distress.

Finally, at the other end of the scale, West Virginia, Mississippi, New Mexico, Alabama, Arkansas, Kentucky, and Louisiana prioritized places that were much less distressed.⁸ In each of these states, roughly 40 percent or fewer selections were from the most distressed areas (figure 1). Indeed, in some states, selections were, on average, less economically distressed than the LICs not picked. In West Virginia, Mississippi, Wyoming, Rhode Island, New Mexico, and South Dakota, neighborhoods designated as Opportunity Zones were actually better off, on average, than eligible communities that were not selected. In Mississippi and West Virginia, for example, the states selected tracts that had lower poverty and child-poverty rates, were better educated, where incomes were rising faster, and where home values were higher than the low-income areas they skipped over.

Recently released data on economic opportunity from the Census and collaborators at Opportunity Insights allow us to examine whether states picked areas that ranked low on socio-economic mobility (Chetty et al 2018). In particular, these data provide information on the income rank as adults of low-income children who grow up in each Census tract—an indicator of the likelihood those children achieve upward economic mobility. On average, Opportunity Zones targeted areas with lower economic opportunity because they tended to target areas with higher poverty rates. However, the correlation of poverty and opportunity is modest, especially when comparing economic opportunity for children born in the early 1980s and poverty rates in the 2010s. Hence, the differences in opportunity for low-income children across eligible and ineligible neighborhoods is small, and in almost all states, there was little difference in economic opportunity between the LICs states selected to be Opportunity Zones and those they did not.

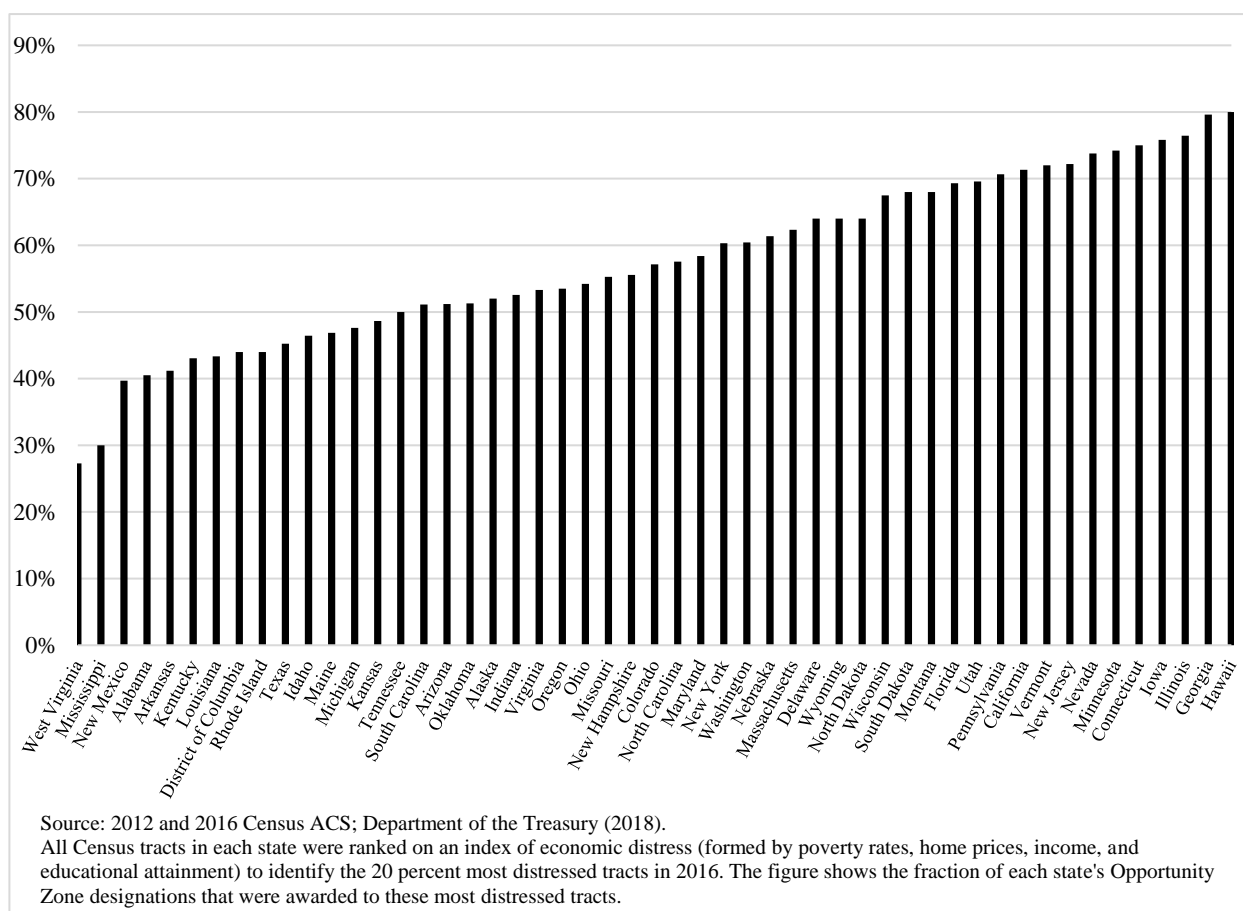
Ultimately, all this means that a smaller share of Opportunity Zone subsidies will accrue to the lowest income, most distressed areas. Indeed, the selection problems are likely to be exacerbated by forthcoming regulations. For instance, Treasury regulations will allow as much as 30 percent of all Opportunity Fund assets to flow to investments outside of Opportunity Zones themselves. Thus, the impact of Opportunity Zones on distressed areas could be diluted even further.

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7. Because of the eligibility rules and distribution of eligible tracts across states, no state could designate more than 19 percent of its tracts as an opportunity zone. Hence, in principle for a state to have used 100 percent of its selections within the most-distressed 20 percent of tracts.

8. Because smaller, higher income states like Rhode Island and DC were allowed to select at least 25 zones, they were effectively constrained to select less disadvantaged areas.

Figure 1. Share of Opportunity Zone Designations from the Most Distressed 20 Percent of Neighborhoods



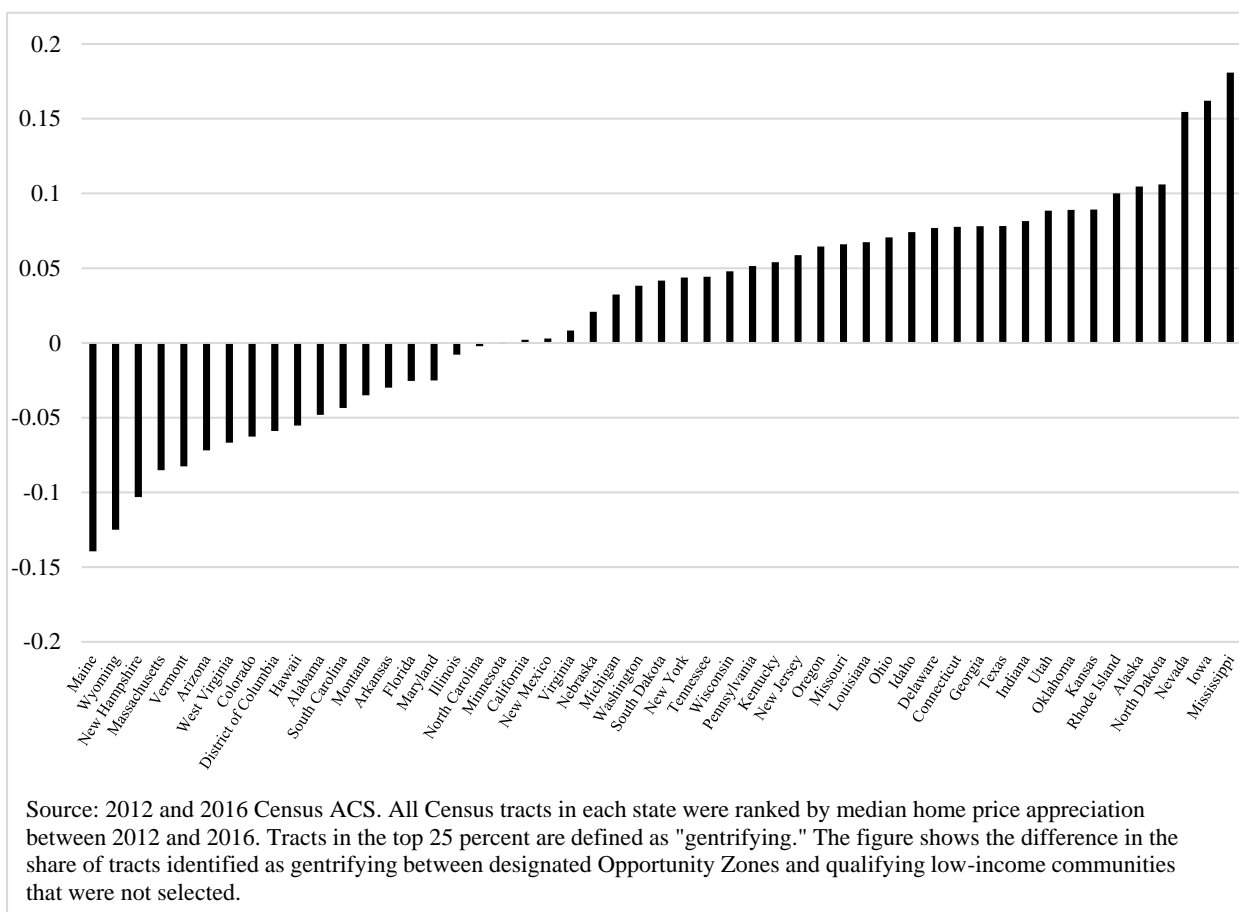
Price Appreciation and Gentrification

Many states selected areas with higher-than-average home price appreciation—one indication of gentrification. Following Baum-Snow and Marion (2009), whose work suggests that place-based subsidies do not increase housing investment in gentrifying areas, we identify tracts where house price appreciation is greater than 75 percent of tracts within their state over the period from 2012 through 2016. Selecting neighborhoods with rising home prices increases the value of the tax benefits to local developers, but reduces the effectiveness and increases the cost of the program. As above, we compared the tracts selected by states to low-income communities they passed over, to assess whether they were more likely to pick places where home prices were rising faster.

Most states selected tracts that had higher home price appreciation than LICs that were not selected, but Mississippi, Iowa and Nevada stand out (Figure 2). In Mississippi, about 40 percent of selected tracts were in higher home-price-appreciation neighborhoods, versus 24 percent of the neighborhoods they passed over. In Iowa, the distribution is 36 percent and 25 percent, and in Nevada, the distribution was 35 percent and 21 percent.

At the other end of the distribution, states such as Maine, Wyoming, New Hampshire and Massachusetts picked more non-gentrifying, low-price appreciation tracts.

Figure 2. Difference in Gentrification (Price Appreciation) between Selected and Not Selected Tracts



So, what went wrong? States had too much flexibility and their incentives were not aligned with Congress's goals for the program.

The starkest example is perhaps Storey County, Nevada.⁹ Storey County was initially unqualified to be designated as an Opportunity Zone based on Treasury's original list of eligible places. The county's median household income is high (\$65,508) and its poverty rate too low. There are only 1,100 families in the County and the family poverty rate in the 2016 Census was 2.6 percent. But, the county boasts the Tahoe-Reno Industrial Center, which houses the Tesla gigafactory, and other major distributors and factories. Nevada policymakers, fueled by a local businessman and campaign contributor, lobbied extensively to get Storey on the list of Opportunity Zones in the state. Clearly, this play was not motivated by a desire to help improve conditions of poor Nevada residents, but instead to deliver tax benefits for Nevada investors. In fact, by designating Storey County, the state had to take the more impoverished Dayton, Nevada off the list. And there are many similar examples across the states. Vermont, for instance, also tried but failed, to change Treasury rules to have an ineligible census tract qualify.

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9. Paletta (2018).

Other place-based policies have been fraught with similar issues. In the Baum-Snow and Marion analysis of LIHTC, the authors present evidence that “developers differentially select gentrifying neighborhoods as locations for their developments” based on the value of the tax credits they are eligible to receive.¹⁰ That is, on the margin, they find that developers submit more applications for proposed projects on land that qualifies for a tax credit compared to similar land that does not.

How to improve targeting of place based incentives

One solution to this problem is for legislators or regulators to define economic distress more accurately, to raise the threshold for what qualifies as distressed, and limit state governments’ ability to pick non-poor areas. Treasury could thereby create stronger guardrails for states to use in making their choices.

The official poverty rate—and the 20 percent threshold—is not good enough. To see this, consider that the Opportunity Zone program uses a definition of poverty that includes college and graduate students. As a result, states picked the campuses of the University of Southern California, Liberty University, Auburn University, Ohio State University, University of Kansas, University of Illinois and University of Maryland, among many others— all of which are located on Census tracts where over 90 percent of residents are students.

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10. Baum-Snow and Marion (2009).

Table 2. College Towns Picked as Opportunity Zones

	Fraction of zone residents enrolled in college	Official Poverty Rate	Census Tract
University of Southern California	99%	88%	222700
Indiana University of Pennsylvania	99%	90%	961102
Illinois State University	99%	87%	200
Liberty University	97%	49%	1400
California State University, Northridge	96%	65%	115103
University of Kansas	96%	61%	400
Western Illinois University	96%	78%	10500
University of Illinois Urbana-Champaign	96%	85%	401
University of Maryland	96%	70%	807200
University of Rhode Island	95%	56%	51400
University of Illinois Urbana-Champaign	95%	78%	5900
Auburn University	94%	75%	40700
University of Illinois Urbana-Champaign	94%	89%	402
Northern Illinois University	94%	75%	2200
Creighton University	93%	37%	1600
University of Wyoming	92%	66%	963500
University of Southern California	92%	84%	224700
Bridgewater State University	91%	33%	561200
Georgia Southern University	91%	74%	110404
New Mexico State University	90%	66%	1000
California State University, Fresno	90%	76%	5408
Purdue University	90%	39%	980001
Auburn University	89%	77%	40800
Tennessee State University	89%	43%	13602
University of Dayton	89%	60%	3402
Texas State University	88%	49%	10200
University of Maryland, Baltimore County	88%	78%	492500
Drexel University	88%	62%	9000
Penn State University	87%	82%	12500
Texas A&M University	87%	74%	2012
University of New Hampshire	86%	40%	80203
University of Illinois Urbana-Champaign	85%	85%	301
Ohio University	85%	80%	973902

Subsidizing college campuses is not what Congress intended. In other instances, selected Opportunity Zones are not what one would expect. These include Dyess Air Force Base in Taylor County, Texas; a waste disposal facility in Wayne County, Michigan; a correctional facility in Florida; and the Philadelphia Zoo—places with few residents and less genuine distress.

One way to improve targeting would be to adjust the official poverty rates to exclude students (a project Census would need to take on using its in-house data). Similarly, Census could produce an estimate of its more comprehensive and accurate Supplemental Poverty Measure at finer geographic levels. Alternatively, policymakers could augment measures of poverty with additional indicators of distress. For instance, unemployment among prime-age workers, educational attainment of local residents, or child poverty rates—or a judicious combination thereof—would provide a more accurate picture of the economic opportunities of local residents.

A second solution is to improve the data that policymakers use to identify economic distress. Opportunity Zones were selected using data from the American Community Survey (ACS) from 2011 to 2015 to determine qualifying status, and states then had the option to use the later 2012 to 2016 iteration if that provided more favorable choices. This meant not only that the data were stale, but also that states could use their own, recent appraisal of economic conditions to pick places that were already on the up and up.

One option would be to ask Census to produce more timely indicators of neighborhood economic conditions. Even though the ACS is based on relatively small samples, Census could produce an indicator of distress that was weighted more toward the most recent data rather than using a straight moving average. Alternatively, Census could draw on new administrative data sources like data on benefit receipt or income (from Social Security or the IRS) for which population-level data is available relatively quickly, and which is now being used to produce measures of local opportunity (e.g., Chetty et al 2018). Indeed, other data sources examining local housing conditions could plausibly be used to inform choices, such as data on price appreciation, like that which is aggregated and published by Zillow, or quarterly vacancy and address data maintained by the Postal Service.

The geographic targeting of incentives is crucial for determining whether place-based incentives are effective and benefit residents of distressed areas. Congress could tighten eligibility standards, use more timely or appropriate data, and target more reliable indicators of long-term distress in future investments or re-authorizations. Improvements in those areas would be especially valuable for programs like Opportunity Zones, which have few guardrails about how the federal subsidies are used.

2. Use Appropriate Financing, Monitor Compliance, and Mandate Transparency

The decision to subsidize Opportunity Zones through an exclusion of capital gains from tax is an unusual choice for spurring investment in distressed areas, and makes the program hard to monitor and difficult to enforce. First, it means most Americans are not eligible to benefit from the tax subsidy. Few American households are eligible to benefit from Opportunity Zones because they simply do not have appreciated capital gains to invest. Apart from their principal residence, most households do not hold financial or other investments outside of retirement accounts, and when they do, the value of their unrealized gains is small. For instance, according to the Survey of Consumer Finances (2016), only 17.7 percent of families have financial assets with an unrealized capital gain, and the median value of the gain is \$5,000.

Second, the capital gains tax is not the principal barrier to most local investments. Indeed, only about 6.5 percent of Americans will pay capital gains tax in 2018, because few actually have any capital gains, many people hold their investments in tax-exempt accounts, and because the statutory capital gains tax rate is zero for most Americans.¹¹ Several other sections of the tax code already allow investors to defer taxes on

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11. Tax Policy Center Table T18-0052.

their capital gains. Section 1031 (more commonly known as like-kind exchanges), for example, allows taxpayers to defer tax on gains if they reinvest the proceeds in a similar property. Special rules in the tax code (section 179 and expensing) allow businesses to deduct the value of capital purchases immediately, allowing deferral of income tax through reinvestment. And the tax code already provides an exclusion of capital gains taxes for investments in small business stock for venture capital and for private equity investors, under Section 1202, who hold investments for five years.

That's not to say that no one pays capital gains. The top income quintile pays 96 percent of the positive tax on capital gains. The top 1 percent bears 80.1 percent of the total burden and the top .01 percent bears 60 percent of the burden.¹² Hence, a relatively small number of taxpayers stand to benefit a great deal from the exclusion of tax on capital gains. Regulations will allow investors to roll gains into the funds and hold them for as long as 30 months without investing them in qualifying investments (provided they have a plan for making qualifying investments), offering considerable flexibility for individuals who want to or are forced to realize large gains to defer and reduce their tax burdens.

Third, unless Treasury or Congress act soon to require some reporting and transparency, it will be impossible to know how many individuals are investing in Opportunity Funds and how much in gains they are deferring, which Zones (and which business activities) they are investing in, what it might cost other taxpayers, and whether it is being abused. This is because the program is run through the tax code and the benefit is in the form of capital gains—which are generally reported only when an asset is sold. Indeed, Section 1202 (the exclusion of gains on small business stock) provides a cautionary tale, because for 1202, as for Opportunity Zones, we have no concurrent information about how much investors are using the provision, what projects are being financed, or how much it is costing us until taxpayers sell their stock many years later and claim the exclusion. (And even then, the IRS does not report which types of activities or businesses benefitted from the exclusion.)

Absent additional Treasury rules and oversight, Opportunity Funds will self-certify their eligibility but provide little other information on their activities. Since there is no third-party reporting, investors will self-report investments in Funds when they make investments and will need to come forward again in 2026 to pay tax on that income (requiring taxpayers and, perhaps, the IRS to retain and track that information over many tax years).

That information will be useful to have in hand over the next few years because the Opportunity Zone legislation was designed to be revised to defer the timing when capital gains taxes are due. Under the law as written, in 2026, taxpayers are supposed to pay tax on their prior capital gains used to finance their original investments—even though they are required to hold onto their investments until at least 2028 (ten years) to benefit from the exclusion of subsequent gains in the fund. Deferring the tax on the prior capital gain until when the Opportunity Zone investments were sold after ten years, however, would have pushed those revenues outside of the 10-year budget window, making the provision too expensive. But as each year passes, the budget window recedes, which could allow policymakers to delay the realization of gains for another year without apparent cost. Unfortunately, that budget treatment ignores the fact that taxes deferred are taxes avoided. That legislation will be a good opportunity to ask whether the program is working and to check in on how much it truly costs.

There is a federal role for additional monitoring and transparency to assess how much investors are putting into these funds and how funds are being allocated, and to provide regular updates on compliance, costs, and beneficiaries. Treasury and IRS should require Opportunity Funds to report their activities—how much investment capital they have raised, to which zones are they directing their investments, and in what kinds of business activities they are investing.

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12. Tax Policy Center (2018).

3. Apply Adequate Guardrails

A second way to make sure distressed communities and local residents benefit from federal subsidies is to clearly designate which projects are eligible and place guardrails on the uses of federal funds. For example, LIHTC regulations include strict criteria for which types of investments qualify, the rents landlords are able to charge, and the characteristics—the income levels—of people who live there. Those rules are designed to ensure that the subsidy builds affordable housing and that the benefits accrue, in part, to low-income families living there. Similarly, the New Markets Tax Credit (NMTC) requires that the organizations that administer the credit (Community Development Entities or CDEs) be held accountable to local residents and have a mission of serving their communities. Once a CDE is certified, however, it must apply for the credits, which are then evaluated by Treasury and are rated based on community benefits. This allows Treasury regulations to prioritize community benefits like affordable housing, or charter schools, or local community investments over investments with only private benefits.

Opportunity Zones, on the other hand, have few guardrails at the federal level. The rules exclude certain ‘sin’ business from benefitting from the tax treatment, and require that investors make substantial new investments or improvements to property they purchase. But otherwise there is little to direct federal subsidies. Proponents bill the absence of guardrails as a benefit—a reduction in complexity and red tape—but that complexity existed only to direct public subsidies to public purposes. It is instead incumbent on states and localities to direct investment. Although they can then use tools that they’ve used before—zoning, local hiring requirements, property or other tax incentives, preservation, assistance to homeowners—there is less leverage than if the federal program instituted rules directing the investments to those more likely to benefit local constituents.

4. Evaluate

Finally, we won’t know whether Opportunity Zones work or are cost effective unless we evaluate the program. The policy is a tax expenditure that operates much like a spending program. Therefore, it requires oversight from the branch of Treasury that administers Opportunity Zones and other place-based tax incentives, and the IRS. Currently, neither of those entities evaluates the effectiveness of the incentives they implement, nor are they slated to implement an analysis of Opportunity Zones. It is possible that Opportunity Zones will end up being costly, regressive, and ineffectual. But they are likely to be popular regardless because the benefits accrue to local projects, and local policymakers can claim credit—in the same way earmarks are popular. If we don’t evaluate programs rigorously, clearly they are going to look like they work—even if they don’t. And that threatens the efficacy not just of the Opportunity Zone program itself but the capacity to improve the next round of place-based programs.

Conclusion

There is a lot we still do not yet know about how the Opportunity Zone program will play out. Evidence from earlier place-based programs shows the importance of targeting and choosing the appropriate guardrails with which to administer the program. With regard to current Opportunity Zone selections, some states appear to have picked a large share of tracts in distressed areas, but many are directing funding to already rapidly gentrified areas where subsidized infusions of capital are not the most economically efficient. If there is sufficient transparency about how Opportunity Zones are implemented, as well as accurate and relevant data on areas picked for the program, then we will be able to appropriately assess the effectiveness of the program into the future. Place-based policies are increasingly attractive to policymakers. But we won't do the next round of place-based programs well if we don't learn from Opportunity Zones.

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