Does Government Play Favorites? Evidence from Opportunity Zones

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The Opportunity Zone Program - TCJA 2017

- Provides Opportunity Zone Funds (OZFs) with tax benefits for investing unrealized capital gains income in designated OZs
- Stated purpose: "Encouraging economic growth and investment in distressed communities by providing federal tax benefits to businesses located within designated boundaries"
- Very wide scope:
 - Covers investments in 25 percent (over 7,000) of low-income tracts
 - Potential to redirect \$6 trillion in capital eligible for reinvestment
- Key feature: governors choose the tracts based on their discretion opportunity for political favoritsm?

The Design of Government Programs

- Lax: Opportunity Zone Program
 - Governors designated OZs in April 2018 from a list of low-income eligible tracts based soley on their own discretion
 - Funds that invest in OZs qualify for tax credits based on self-reporting without any disclosure requirements
- Merit-based: Community Development Financial Institutions
 - Certification: must direct 60 percent of their financing activities to low-income areas
 - Must apply for government subsidies based on a competitive process and enter into an assistance agreement with the CDFI Fund

The Promise Of Opportunity Zones Is In Reach Forbes

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There is \$6.1 trillion in capital gains taxes available for reinvestment in economically distressed areas known as 'Opportunity Zones,' and we must ensure that communities and entrepreneurs are deeply engaged as this investment unfolds.

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THE BONANZA

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Opportunity Zones Knock Where They're Needed Least

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Tlaib introduces bill to repeal 'opportunity zones'

BY NAOMI JAGODA - 11/22/19 04:10 PM EST

Does Favoritism Predict OZ Designation?

- Favoritism Measures
 - Voter support (vote share for governor)
 - Investor contribution (campaign contributions to governor)
- Economic factors
 - High distress levels (income, poverty, unemployment)
 - Economic improvement (↑ income, ↓ poverty)

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+ preliminary evidence of impact of OZ designation and favoritism on investment

Qualification as Opportunity Zone Funds

- To qualify as Opportunity Zone Funds (OZFs), investors need only to self-certify to the IRS when filing their tax returns that they are:
 - Acquiring or substantially improving tangible property
 - Acquiring stock or a partnership interest in an Opportunity Zone Business
- OZFs are entitled to tax benefits:
 - Defer tax on capital gains reinvested in OZs until the sale of the investment or 2026
 - Reduce tax rate by 10 percent if investment is held for five years, 15 percent if investment is held for seven years
 - Eliminate tax on additional capital gains on the appreciation of the investment if it is held for ten years

OZ Eligibility Criteria

- OZs are Census tracts nominated in writing by the governor of each state (2018)
- To be eligible for selection, the tract must either:
 - Qualify as a "low-income community" (LIC)
 - Poverty rate \geq 20 percent; or
 - Median family income (MFI) \leq 80 percent statewide MFI (or metropolitan area MFI)
 - Be contiguous to an OZ
 - Capped at 5 percent of OZs in each state
 - MFI in contiguous tract cannot exceed 125 percent of MFI in OZ
- Up to 25 percent of LICs in each state may be designated as OZs

Considerations in OZ Designation

- Governors have significant discretion in choosing which tracts to designate as OZs
- Guided to provide particular consideration to areas that:
 - Are currently the focus of mutually reinforcing state, local, or private economic development initiatives to attract investment and foster startup activity
 - Have demonstrated success in geographically targeted development programs such as promise zones, the new markets tax credit, empowerment zones, and renewal communities; and
 - Have recently experienced **significant layoffs** due to business closures or relocations
- No detailed review process of the decision
- Particularly striking because benefits are provided by the federal government

Related Literature

Design and impact of programs to promote development

- Empowerement Zones: Busso, Gregory, and Kline (2013), Ham et al. (2011), Wallace (2003)
- CDFI/NMTC Programs: Freedman (2012), Cortes and Lerner (2013), Kovner and Lerner (2015)
- Opportunity Zones: Chen et al. (2019), Sage et al. (2019)
- Political connections and governmental decisions
 - Governors reward political supporters (Ansolabehere and Snyder, 2006)
 - Studies that evaluate the impact of campaign contributions by firms and their executives (Gordon et al., 2007; Bonica, 2016).
 - Corporate influence on government decisions (Duchin and Sosyura, 2012; Cohen and Malloy, 2014; Fang et al., 2018; Bertrand et al., 2018)



- Opportunity Zone Eligibility and Designation (tract)
 CDFI Fund; 2018
- Distress Measures and Covariates (tract)
 - American Community Survey; 2010-2017
- NMTC/EZ Receipt (tract)
 - CDFI Fund, HUD; 1994-2017
- Governor Support (county)
 - CQ Press Voting and Elections Collection; most recent
- Campaign Contributions
 - FollowTheMoney; 2014-2018
- Private Investment and Firm/Company Executives
 - VentureXpert; 2003-2018

Investor Contributions to Governors' Campaigns

• FollowTheMoney:

- Identify governor in office at time of OZ selection for each state
- Keep campaign contributions above \$1000 to governor in pre-OZ election cycle and 2018 cycle, if applicable
- VentureXpert:
 - Construct aggregate private investment for each tract from May 2003 April 2018
 - Identify investor firm and investee company executives
 - Match based on first and last name to campaign contributions, manually verify
 - 1379 individual and 146 non-individual contributors
 - Associate investor contributions with Census tract(s) where each investee company is located

Investor Contributions



- Investee company executives matched by name and own state
- VC/PE firm executives matched by name and investee company state
- 559 tracts are associated with a contribution, 232 of those are OZs

Validation with Anecdotal Evidence

- Collect 45 News Reports on Questionable Designations:
 - Tract in Manhattan which is home to offices of Pershing Square (Bill Ackman)
 - Four tracts in Portland in the 93rd percentiles in median income (incl. one that experienced 600% growth)
 - Tract in Houston Texas that as of 2017 had a median family income of \$250,000
- Validation of Favoritism Measure:
 - 29 tracts (64%) are located in counties with more than 60% voter support (compared to 40% for all OZs)
 - 14 tracts (31%) are located in tracts with more than \$1000 investor contribution (compared to 3% for all OZs)

The Number of Designated OZs by In-State Percentile



Comparing Trends Between OZ and non-OZ Census Tracts



Empirical Specification

• Logit specification:

$$OZ_{ij} = \alpha + \beta VS_{ij} + \gamma IC_{ij} + \delta X_{ij} + \zeta \Delta X_{ij} + \eta_j + \varepsilon_{ij},$$

- $OZ_{ij} = 1$ if tract *i* in state *j* is designated as an OZ
- $VS_{ij} = 1$ if the support for the governor in the county in which tract *i* is located is above 60 percent.
- $IC_{ij} = 1$ if the campaign contributions to the governor by investors in tract *i* are above \$1000
- X_{ij} = tract-level explanatory variables: (1) key variables (income, poverty, unemployment), and (2) additional variables (e.g., population density, home value, private investment)
- ΔX_{ij} = changes in X_{ij} between the years 2015 and 2010
- η_i = state fixed effects
- $\varepsilon_{ij} = \text{error term clustered by state}$

The Likelihood of Opportunity Zone Designation

	(1)	(2)	(3)	(4)	(5)	(6)	(7)
Voter Support \geq 60%	0.0161 (0.0226)	0.0356 (0.0257)	0.0355 (0.0262)	0.0568** (0.0238)	0.0456** (0.0216)	0.0560** (0.0240)	0.0453** (0.0218)
Investor Contribution \geq \$1000	0.0730*** (0.0255)	0.0793*** (0.0253)	0.0775*** (0.0260)	0.0717*** (0.0244)	0.0643*** (0.0245)	0.0728*** (0.0246)	0.0657*** (0.0244)
log(1+Private Investment)	0.00551*** (0.00152)	0.00689*** (0.00133)	0.00671*** (0.00131)	0.00607*** (0.00112)	0.00530*** (0.00107)	0.00576*** (0.00114)	0.00513*** (0.00109)
Median Family Income		-0.00231*** (0.000779)	-0.00275 ^{***} (0.000873)	-0.000797 (0.000674)	-0.000354 (0.000610)	-0.000787 (0.000779)	-0.000173 (0.000713)
Poverty Rate		0.00383 ^{***} (0.000891)	0.00390 ^{***} (0.000734)	0.00362*** (0.000977)	0.00306*** (0.00103)	0.00390 ^{***} (0.000814)	0.00325 ^{***} (0.000867)
Unemployment Rate		0.00527* (0.00281)	0.00480* (0.00259)	0.00515* (0.00280)	0.00529* (0.00280)	0.00441* (0.00254)	0.00554 ^{**} (0.00259)
Δ Median Family Income			0.00155*** (0.000345)			0.000582 ^{**} (0.000278)	0.000154 (0.000276)
Δ Poverty Rate			-0.000991 (0.000610)			-0.00101* (0.000581)	-0.000535 (0.000551)
Δ Unemployment Rate			0.000322 (0.00105)			0.000750 (0.000948)	-0.000347 (0.000931)
Observations	30826	30826	30826	30826	30826	30826	30826
Pseudo R ²	0.0062	0.0491	0.0513	0.064	0.0784	0.0682	0.0812
State Dummies	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Level Covariates Change Covariates NMTC/Metro Dummies				\checkmark	√ √	√ √	\$ \$ \$

Addressing Selection Issues

Tracts associated with voter support and investor contribution have different characteristics than other tracts (e.g., higher income)

- Matching Estimators (Observables):
 - Match tracts with Voter Support \geq 60% to other similar tracts
 - Match tracts with Investor Contribution 2\$1,000 to other similar tracts
 - Matching criteria: income, poverty, unemployment, private investment, changes in distress, etc.
- Bounding Exercise (Unobservables):
 - Calculate the lower bounds of the effects of favoritism as if unobservable factors determine selection (Altonji et al., 2005; Oster, 2019)
 - Assumption: unobservables have the same effect on selection as observable factors

The Likelihood of OZ Designation: Matching Estimators



- A1: Exact match within state. Nearest neighbor match on key variables (levels).
- A2: Exact match within state. Nearest neighbor match on key variables (levels and changes).
- A3: Exact match within state and metro status. Nearest neighbor match on key variables (levels and changes).
- A4: Exact match within state, metro status, and NMTC/EZ status. Nearest neighbor match on key variables (levels and changes).
- A5: Exact match within state. Nearest neighbor match on key and additional variables (levels).
- A6: Exact match within state. Nearest neighbor match on key and additional variables (levels and changes).
- A7: Exact match within state and metro status. Nearest neighbor match on key and additional variables (levels and changes).
- A8: Exact match within state, metro status, and NMTC/EZ status. Nearest neighbor match on key and additional variables (levels and changes).

The Likelihood of OZ Designation: Matching Estimators



B1: Exact match within state and metro area. Nearest neighbor match on key variables (levels).

B2: Exact match within state and metro area. Nearest neighbor match on key variables (levels and changes).

B3: Exact match within county. Nearest neighbor match on key variables (levels).

B4: Exact match within county. Nearest neighbor match on key variables (levels and changes).

B5: Exact match within state and metro area. Nearest neighbor match on key and additional variables (levels).

B6: Exact match within state and metro area. Nearest neighbor match on key and additional variables (levels and changes).

B7: Exact match within county. Nearest neighbor match on key and additional variables (levels).

B8: Exact match within county. Nearest neighbor match on key and additional variables (levels and changes).

Bounds Accounting for Selection on Unobservables

	(1) Voter Support $\geq 60\%$	(2) Investor Contribution \geq \$1000					
Baseline Effect (Std. Error) $[R^2]$	$\begin{array}{c} 0.0153 \\ (0.0183) \\ [0.0003] \end{array}$	0.1702*** (0.0344) [0.0028]					
Controlled Effect (Std. Error) $[R^2]$	0.0430^{*} (0.0219) [0.0904]	$\begin{array}{c} 0.0762^{**} \ (0.0291) \ [0.0904] \end{array}$					
$R_{max} = 1.3 \times R^2 = 0.1175$							
Identified Set δ for $\beta = 0$	[0.0430,0.0552] -5.8703	[0.0332, 0.0762] 1.6369					
$R_{max} = 1.5 \times R^2 = 0.1356$							
Identified Set δ for $\beta = 0$	[0.0430,0.0648] -3.6102	$[-0.0011, 0.0762] \\ 0.9881$					

Simulated OZ Tract Changes: No Voter Support



Simulated OZ Tract Changes: No Investor Contributions



Simulated OZ Tract Changes: No Favoritism



Robustness Checks

- Using linear regression instead of logit model
- Controlling for other levels of Voter Support
 - Voter Support 50-60% = no effect
 - Voter Support $\geq 70\% = strong$ effect
- Excluding states not represented in VentureXpert from sample
- Limiting matching process to tracts with company in VentureXpert
- Using \$3000 instead of \$1000 threshold for Investor Contribution
- Measuring ACS covariates in 2017 instead of 2015
- Measuring favoritism variables as continuous variables instead of dummies

Impact of Favoritism on Investment (Preliminary Evidence)

• Triple DID design:

- Dependent variable: the log of investment (early/late stage) in a tract in each quarter
- \bullet Interaction: OZ designation \times Investor Contribution \times Quarter dummies
- Controlling for tract and county-year fixed effects and clustering at tract level
- Findings:
 - OZ designation has no effect on investment levels both early and late stage
 - Investor favoritism has no effect, except for a jump in late-stage investment in the first quarter after designation

Investor Favoritism and Late-Stage Investment



Conclusion

- Lax designation requirements may be tainted by political favoritism, and may result in allocating tax benefits to profit-maximizing funds
- On the bright side, governors do take into account economic distress in OZ designation
- Too early to determine the outcomes of the OZ program and favoritism in OZ designation (but early evidence suggests no material positive impact on investment)