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Opportunity Zones

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Chairman Pascrell, ranking member Kelly, thank you for inviting me to this hearing on Opportunity Zones.

I am a senior fellow and director of the Hutchins Center on Fiscal & Monetary Policy at the Brookings Institution. The views I express here are strictly my own and should not be attributed to the Brookings Institution, its donors, or other scholars. I joined Brookings in 2014 after 30 years as an economic-policy reporter, editor, and columnist at The Wall Street Journal. Relevant for this hearing, I am the author of *Only the Rich Can Play*, which was published in October.[1] The book reprises the history of place-based policies such as Jack Kemp's Enterprise Zones and Bill Clinton's Empowerment Zones and New Markets Tax Credit and traces the origins of the Opportunity Zone legislation to Sean Parker of Napster and Facebook fame and the think tank he funded to propel it into law, the Economic Innovation Group. It then looks at what happened after the law was passed -- in governor's offices and at the Treasury – and, at this admittedly early stage, what I found in two years of reporting in Opportunity Zones across the country from Portland, Oregon, to Baltimore.

To summarize my observations: The problem that Opportunity Zones were supposed to address is a significant one: the large and widening gap between communities that are prospering and those that are being left behind. This is particularly worrisome since Americans are increasingly less likely to move than they once were.[2] Proponents of Opportunity Zones see this capital-gains tax break as a solution to geographic inequality. Providing people with money an incentive to put it into capital-starved poor communities sounds good. Without question, there are places where OZs are working as the proponents promised, including downtown Erie, Pennsylvania, which John Persinger will discuss today, and SoLa Impact, which is using OZ money for affordable housing in South LA. But there are 8,764 OZs, and **nothing** in law or regulation requires OZ investors to put their money into those census tracts that really need the money or into projects that will benefit the people who live in the zones. The available evidence

[1] David Wessel, *Only the Rich Can Play: How Washington Works in the New Gilded Age,"* Public Affairs, 2021.
[2] William H. Frey, "For the first time on record, fewer than 10% of Americans moved in a year," Brookings Institution, November 22, 2019. https://www.brookings.edu/blog/the-avenue/2019/11/22/for-the-first-time-on-record-fewer-than-10-of-americans-moved-in-a-year/

and my reporting suggest that the bulk of the money is going to real estate projects that would have been done otherwise or projects that will not do much to improve the lives of the low-income residents of the zones. Proponents and drafters of the Opportunity Zone legislation were so determined to make the tax break attractive to wealthy investors and so allergic to oversight from Washington -- which they argued limited the effectiveness of other place-based policies -- that they avoided the guardrails and oversight that might have directed more money to places and people most in need of private investment. They also underestimated the cleverness and aggressiveness of the huge industry of accountants, lawyers, wealth advisers and real estate fund managers who find every possible way to exploit the tax code to save their clients' money. I fear that when we finally get all the data, we will learn that Opportunity Zones did more to cut taxes for the wealthy than to improve the lives of people who live in the zones.

By what standard should we judge OZs?

While the statute itself doesn't give a purpose, the IRS says: "Their purpose is to spur economic growth and job creation in low-income communities while providing tax benefits to investors.[3] The Economic Innovation Group says: "Opportunity Zones (OZs) were designed with a simple premise: the tax code should encourage private investment in communities that are struggling to attract capital, create jobs, and lift residents out of poverty."[4] These are unquestionably worthy goals. We need to ask if Opportunity Zones, as designed and administered, are achieving them?

What reliable data do we have to evaluate OZs?

The short answer is not much. Unfortunately, a reporting requirement was stripped out of the Tax Cuts and Jobs Act as the bill was steered through the reconciliation maze in the U.S. Senate. The IRS is collecting some information from OZ investors and OZ funds, but only shards of that are available to scholars or the public. We don't even know with confidence how much money has been raised by OZs and how much of that money has been invested.

According to a recent Government Accountability Office report, the IRS says that OZ funds raised at least $29 billion through 2019.[5] I suspect at least at least as much money has been raised since the end of 2019, but we don't really know.

Patrick Kennedy of the Joint Committee on Taxation and Harrison Wheeler, both of whom are Ph.D. students at the University of California, Berkeley, got access to OZ funds' electronically filed Form 8996s for 2019, which represent 75% of the returns filed that year.[6]

The administrative data we have is unfortunately limited because, as I understand it, few if any of 2018 OZ returns have been digitized and 19% of 2019 OZ fund returns that, according to the GAO, were filed on paper; most of those aren't yet digitized. I strongly agree with the

[3] IRS, "Opportunity Zones," https://www.irs.gov/credits-deductions/businesses/opportunity-zones (accessed Nov. 12, 2021).

[4] Economic Innovation Group, "Opportunity Zones," https://eig.org/opportunityzones (accessed Nov. 12, 2021).

[5] Government Accountability Office, "Opportunity Zones: Census Tract Designations, Investment Activities, and IRS Challenges Ensuring Taxpayer Compliance," GAO-22-104019, Oct. 7, 2021. https://www.gao.gov/products/gao-22-104019

[6] Patrick Kennedy and Harrison Wheeler, "Neighborhood-Level Investment from the U.S. Opportunity Zone Program: Early Evidence," April 15, 2021 https://static1.squarespace.com/static/57a3c0fcd482e9189b09e101/t/607893b915858d7bd0d198ba/1618514881004/oz_kennedy_wheeler.pdf

GAO that transcribing paper OZ returns should be a very high priority for the IRS so we can evaluate this significant federal initiative. (I also wonder whether the IRS could at least strenuously encourage if not require that OZ funds file electronically. After all, we're not talking about the typical American filling out a Form 1040 at the kitchen table. Kennedy and Wheeler find the average household income for OZ investors in 2019 was estimated at $1.1 million.)

Where is OZ money flowing?

All indications are that the bulk of the money is going to real estate projects. That wasn't Sean Parker's intent. He told me he was hoping money would flow to new businesses. That didn't happen. In part, that's because the contours of the law are more appealing to real estate investors than venture capitalists; in part, that's because Treasury regulations on real estate preceded those for investing in businesses; and in part, because the real estate industry is so experienced at taking advantage of tax breaks. When I went to an Opportunity Zone Expo in May 2019 at the Mandalay Bay Resort & Casino in Las Vegas – which is, by the way, located in an Opportunity Zone – one expert joked that 1031 and EB-5 had a love child and that was Opportunity Zones. (In most audiences, that line gets blank stares. I'm hoping that's not the case at this subcommittee.). The OZ tax incentive has a couple of features that particularly appealing to real estate. In a 1031 like-kind exchange, an investor must put the gross proceeds of a sale into a new property to defer capital gains taxes; in an OZ, however, an investor needs only put the capital gains – not the gross proceeds -- into the OZ fund to get the tax break. Moreover, real estate investors depreciate their property over time and face depreciation recapture at ordinary income tax rates when the property is sold. In an OZ investment, there is no depreciation recapture.[7]

On average, census tracts designated as OZs are poorer than those that were not eligible, but being designated as an OZ doesn't guarantee a zone will get any money. Kennedy and Wheeler found that 84% of the 8,764 Opportunity Zones got no OZ investment at all and half the money when to best off 1% of the zones. "When compared to other OZ tracts with zero investment," they said, "tracts that receive investment have relatively high educational attainment, home values, and incomes, as well as lower unemployment and higher shares of prime-age workers…[T]he preliminary descriptive evidence suggests that OZ capital may disproportionately benefit a narrow subset of tracts in which economic conditions were already improving prior to implementation of the tax subsidy." This is not surprising: Most (though not all) investors are looking for the highest return with the lowest risk rather than the highest social return. There is no requirement or even incentive for OZ funds to create new, good jobs for zone residents or increase the supply of affordable housing. Almost anything goes. So we get hotels, condos, self-storage facility and high-end student housing.

Without hard data, we have to settle for what some deride as "anecdotes," but I call "reporting." Here's some of what I found:

The governor of Oregon designated much of downtown Portland, Oregon, as an OZ and there are several big projects there benefiting from OZ financing. One is the Ritz-Carlton hotel and condo where one bedrooms are to start at $1.6 million and penthouses at more than $7 million. Another is the headquarters of NW Natural, the local gas utility. It was financed, under construction, and fully leased in October 2017 -- before the TCJA passed -- but because the certificate of occupancy hadn't been issued, it counted as "new investment" when an OZ fund

[7] Clay McCarter, "The 2 Hidden Benefits of Opportunity Zone Investing," OpportunityDb, February 25, 2020. https://opportunitydb.com/2020/02/hidden-benefits-of-opportunity-zone-investing.

bought it in October 2019. As Todd Gooding, a Portland developer, put it to me: "There's nothing wrong with the NW Natural Gas deal. The Ritz-Carlton is a great project. But is it going to change the neighborhood? Is it going…to have the impact an Opportunity Zone investment is supposed to have? I don't think so." Meanwhile, about 15 miles east of downtown is the community of Rockwood, where many poor and often African American and Hispanic folks have moved after being pushed out of pricier Portland neighborhoods. It, too, is an OZ, but has drawn very little OZ money.

Baltimore is the sort of city that could use some help attracting private money. Pastor Dante Hickman of the Southern Baptist Church in East Baltimore was so excited about the potential for OZs to help his economic-development efforts in that struggling neighborhood that he went to the White House, stood next to President Trump at an OZ-focused event, and said he was "thanking you in advance for funding and resources that you will direct to the urban and distressed communities like Baltimore." That was in 2018. Today, Pastor Hickman is disappointed. "We have met with all kinds of investors. All came with the terminology -- opportunity, mission-driven projects. But the mission was all about how much money they could make out of a project. Can we get our 10 percent to 12 percent? But when it turned out that the project could not yield the kind of interest that they wanted, then there was no opportunity for us, and there was no interest from them."[8]

There is one huge retail, residential and office project in Baltimore that is, in part, financed with OZ money: Port Covington, which eventually will cover the equivalent of 45 city blocks. Before OZs were created, Port Covington had $660 million in Tax Increment Financing from the city, among other tax breaks, plus $233 million from Goldman Sachs. So some subsequent investors are getting OZ tax breaks for a project that already had substantial subsidies and already had enough promise that Goldman Sachs put its own money into it.

I also found OZ money flowing to self-storage projects, which employ hardly any people, and to luxury student housing in several census tracts around big universities – including Champagne-Urbana, Illinois, and Louisville, Kentucky -- that qualified as OZs only because students show up in the Census as low income.

One area where we simply don't know enough: Are big corporations using the OZ provision in ways that cut their taxes but don't provide much economic benefit to a community, such as locating cell phone towers on top of buildings in OZs?[9]

Let me emphasize that there are OZ projects delivering on the stated goals of the initiative. I describe several of them in my book – and I note that EIG is holding a webinar at the same time as this hearing to highlight such examples. My reporting suggests that these are the minority, but I am prepared to change my mind if the data prove otherwise. By design, this program allows investors to cherry-pick the best, more profitable projects

By attracting more investors and lowering the cost of borrowing, the OZ tax break is – as the GAO interviews suggest – are allowing some, perhaps even many, developers to finance projects they might not otherwise have done or to accelerate them. But that's not the only standard for judging OZs. As Aaron Seybert of the Kresge Foundation puts it: "More money is

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[8] "Trump-era Opportunity Zones meant to help low-income communities exploited by investors," PBS NewsHour, Nov. 12, 2021. https://www.pbs.org/newshour/show/trump-era-opportunity-zones-meant-to-help-low-income-communities-exploited-by-investors

[9] Noah Buhayar, "Trump Tax Break's Hidden Frenzy: Corporate Giants are Rushing In," Bloomberg, Dec. 12, 2019. https://www.bloomberg.com/news/features/2019-12-12/filing-frenzy-shows-companies-lining-up-for-poor-area-tax-breaks

not always better. OZ doesn't require measurement, accountability or tracking of any impact beyond dollars in; it rewards appreciation regardless of social impact. This is not a worthy measure. If millions go into a community, but they're invested into …storage units, and condominiums that price people out of housing opportunity, are the people who live there any better off?"[10]

Why isn't more OZ money going for the stated purpose?

Several reasons:

1) Choice of zones. The law made 56% of all census tracts eligible and empowered governors to choose up to 25% of the eligible tracts. Some governors chose wisely; some did not. Fully 25% of New York State's OZs are in booming Brooklyn. The city of Austin, one of the fastest growing metro areas in the country, asked for four zones; the governor gave it 21. The law allowed governors to designate as OZs certain census tracts that don't qualify as low-income but are contiguous to OZs. Only 2.5% of the 8,764 tracts chosen as OZs are so-called "contiguous zones" but the Joint Tax Committee estimated that these tracts got more than 6% of OZ money in 2019.[11] The Trump Treasury could have exercised more oversight over governors' choices, but it didn't question any governors' decisions.,
2) The paucity of rules or guardrails.
    a. By referencing an earlier statute, Congress excluded from OZ eligibility golf courses, country clubs, massage parlors, hot tub facilities, racetracks or other gambling facilities and liquor stores. Anything else goes. I noticed recently that an OZ fund called Bit Capital Fund says it is raising money to acquire " large inventories of computers – equipped with high-powered processing systems (CPUs and GPUs) – that generate income by processing transactions on block chain ledgers in order to yield digital currencies for the funds' limited partners (both long term and short-term strategies)."[12] And a Miami OZ fund wants to developed a bitcoin mining operation in Homestead, Florida, according to *The Real Deal.*[13]
    b. OZ funds "self-certify" with no requirement that they even assert that they intend to invest in projects that'll benefit residents of a community. I am intrigued by language in the Joint Tax Committee's explanation of the OZ provision: "The provision intends that the certification process for a qualified opportunity fund will be carried out in a manner similar to the process for allocating the new markets tax credit. The Secretary is granted the authority to administer this process." The Treasury did not see it this way. Brett Theodos, who is testifying today, has called for "a rigorous certification

[10] Aaron Seybert, "Mission, Money & Markets: Is 2021 a turning point for the Opportunity Zones incentive?," Kresge Foundation, June 10, 2021. https://kresge.org/news-views/mission-money-markets-is-2021-a-turning-point-for-the-opportunity-zones-incentive/

[11] Joint Committee on Taxation, "Selected Topics Relating to Tax and Infrastructure," JCX-25-21, May 21, 2021, p. 39. https://www.jct.gov/publications/2021/jcx-25-21/

[12] "Bit Capital, The First Cloud-Computing Opportunity Zone Fund." https:///bitcapital.fund/ (accessed Nov. 12, 2021)

[13] Francisco Alvarado, "Opportunity Zone fund proposes Bitcoin mining project near Homestead speedway," *The Real Deal*, Sept. 16, 2021. https://therealdeal.com/miami/2021/09/16/opportunity-zone-fund-proposes-bitcoin-mining-project-near-homestead-speedway/

process" for OZ funds.[14] EIG objects, arguing that requiring OZ funds to be certified would choke off investment. Surely there is some middle ground between onerous bureaucracy and anything-goes self-certification.[15]

c. The IRS did issue pages of rules and guidance. But as Steve Glickman, one of the co-founders of EIG, put it during a January 2020 webinar: The regulations got "consistently more taxpayer friendly," a refrain I heard repeatedly during my reporting. In other words, both the law and the regulations seem focus more on attracting investors than in making sure that the investments benefit residents of OZs.

3) Aggressiveness and cleverness of the tax-avoidance industry. The downside of using the tax code to try to direct private money to purposes and places that Congress desires is that there are lots of very smart, very well-paid people who find and exploit the provision for unintended purposes. I believe the designers of the OZ tax incentive underestimated this.

What should happen?

Assuming the OZ provision isn't repealed, I offer the following recommendations:

1. **Get better data.** Treasury should -- -and if it doesn't then Congress should – collect and release more data and soon; on that, fans and critics of OZs agree. Where is OZ money going? How much money to which zones? For what? And for whose benefit? It is important that this data not be collected by the IRS in a way that limits public disclosure or evaluation of OZs by independent scholars. I urge this subcommittee to use its influence and authority to get more data on OZs.
2. **Revisit zone designations.** With 8,764 zones, it is not surprising that the money is flowing to the best-off zones, some of which were poor choices. The GAO found that half the states and territories could change tracts designated as OZ, 16% wouldn't, and the remaining 38% weren't sure or didn't answer. Any redesignation should rely on the most current data (to avoid census tracts that once looked very poor but are already drawing lots of private money) and should be subject to public comment before becoming final.
3. **Limit the projects for which the OZ tax break can be used**. We don't need to provide tax incentives for projects like self-storage facilities or luxury student housing in college towns and buildings that are finished except for a certificate of occupancy. Sen. Ron Wyden would require that any residential property taking advantage of OZ tax incentives have a minimum amount of affordable housing; that's an idea worth considering.
4. **Consider bigger tax incentives for projects in the most economically depressed communities** so that more OZ money goes to places that really need it. The one-size-fits-all approach inevitably will direct money to places already attractive to investors.

[14] Brett Theodos, testimony, House Committee on Small Business, Oct. 17, 2019. https://www.urban.org/sites/default/files/publication/101207/a_tailored_opportunity_zone_incentive_could_bring_greater_benefits_to_distressed_communities_and_less_cost_to_the_federal_government.pdf

[15] "Recommendations for Legislative and Regulatory Modifications to Opportunity Zone Incentive," Economic Innovation Group et. al., March 21, 2021. https://eig.org/wp-content/uploads/2021/03/EIG-Opportunity-Zones-Coalition-Policy-Recommendations-Letter.pdf

5. **Encourage training and hiring of OZ residents**. Both Kemp's Enterprise Zones and Clinton's Empowerment Zones offered incentives for hiring. Economists once preached: Invest in people, not in places. Many of them have changed their minds. But any place-based incentives should also encourage, if not require, investing in people as well. David Neumark, an economist at the University of California, Irvine, who is skeptical about OZ-style tax breaks, has proposed that the federal government subsidize employment in communities that are struggling.[16]

During his campaign, President Biden said he would "direct" the Treasury to "review" OZs to make sure the investors provided "clear economic, social, and environmental benefits to a community, and not just high returns – like those from luxury apartments or luxury hotels – to investors." [17] As far as I know, we've yet to see anything from Treasury and I'm not aware of any provisions in the Build Back Better legislation that would improve the program.

Critics of the Opportunity Zone program will identify unworthy projects and condemn the effort. Proponents will say those are exceptions and defend the program. We don't need to wait for detailed data and analysis to revise the law and regulations to get more of the investments that improve the lives of people in poor communities and fewer of those that don't.

[16] David Neumark, "Rebuilding Communities Job Subsidies," Hamilton Project, Brookings Institution, Sept. 28, 2018. shttps://www.hamiltonproject.org/papers/rebuilding_communities_job_subsidies

[17] Biden for President, "The Biden Plan to Build Back Better by Advancing Racial Equity Across the American Economy," https://joebiden.com/racial-economic-equity (Accessed Nov. 12, 2021.)