Opportunity for Whom?
A Call for Course Correction Based on Early Opportunity Zone Investments

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Something has gone wrong in America. Starting in the early 1980s, following a three-decade decline in America's wealth gap, the household income per-capita gap between the wealthy and poor reversed its positive trajectory and began a steady rise toward the current alarming level of inequality.[1] By 2016, the country's wealthiest households held 77% of the nation's total wealth, while the poorest households held only 1%.[2] This trend has had an unmistakable geographic element: as the wealthy continue to get wealthier and the poor poorer, the poorest communities are largely concentrated in the Rust Belt and southern states, while wealth and opportunity gravitate to major urban centers largely on the coasts.[3] Today, more than 50 million Americans live in economically distressed communities.[4] Those communities tend to offer very little economic mobility for residents, all but guaranteeing deeper and more entrenched intergenerational poverty. Such is the picture of wealth inequality in America today.

Enter Opportunity Zones (OZ). Included in the Tax Cuts and Jobs Act of 2017 (TCJA)—and based on a previous bill that Sen. Tim Scott (R-SC) co-sponsored with colleagues on both sides of the aisle, including Sen. Cory Booker (D-NJ)—the Opportunity Zones legislation sought to address growing economic inequality in low-income census tracts through federal tax incentives that encourage private investment in these communities. The Act recognized that barriers to accessing capital are a common contributor to economic inequality, since many areas in the nation have little to no market for new development and investment. The sponsors believed the flow of capital to coastal cities through private equity and venture capital, which largely avoided midwestern and southern states, was a major driver of this growing inequality. Champions of the legislation often cited the fact that in 2016, the year before the TCJA was passed, 75 percent of venture capital money went to startups in just three states: California, Massachusetts and New York. Surely, the thinking goes, talent must be more geographically

[1] Ana Kent, Lowell Ricketts, and Ray Boshara, "What Wealth Inequality in America Looks Like: Key Facts & Figures," *Open Vault Blog* (blog), *Federal Reserve Bank of St. Louis*, August 14, 2019, https://www.stlouisfed.org/open-vault/2019/august/wealth-inequality-in-america-facts-figures.
[2] Kent et al. "What Wealth Inequality in America Looks Like: Key Facts & Figures."
[3] Raj Chetty et al., "The Fading American Dream: Trends in Absolute Income Mobility Since 1940" (working paper, National Bureau of Economic Research, Cambridge, MA, December 2016).
[4] Economic Innovation Group, "Over 50 Million Americans Live In Economically Distressed Communities," News release, (February 25, 2016).

distributed than that. Proponents of Opportunity Zones believed that the capital expected to follow the tax incentives could be the tool to rebalance this lopsidedness.

This theory, on its own, is compelling. We do agree with the general sentiment that traditional capital markets often irrationally overlook investable opportunities in both rural/non-major metro and urban low-income communities, perceiving them to be riskier than they actually are. However, we also believe—and, in fact, have observed first hand—that it does not automatically follow that a tax incentive such as Opportunity Zones will naturally result in a sudden wave of capital flowing into overlooked communities—and certainly not necessarily in ways that actually benefit low-income communities and the people who live there. More is required.

Specifically, what is required is a deep understanding of the assets and needs of low-income communities and the types of capital required to build upon the assets and meet the needs. If done right, Opportunity Zones can be a powerful tool to foster mixed-income, truly integrated communities where wealth is shared and opportunity is abundant. If done wrong—that is, without further action and improvements to its current form—the Opportunity Zones legislation has potential to exacerbate the problems of inequality it was meant to remedy. Its success is dependent on a range of stakeholders, from policymakers to investors to community residents themselves, to ensure that the process is transparent, that it receives proper buy-in from those who will be impacted, and that investments are ultimately consistent with what communities need.

How Opportunity Zone Incentives Work

In its simplest form, the Tax Cut and Jobs Act created four new tax incentives for capital gains investors with liquid capital gains:

1. Investors may gain temporary deferral of existing capital gains that are reinvested into Opportunity Funds;
2. If investors hold their Opportunity Fund investments for five years, the basis of their original investment is increased by 10 percent (meaning they will only owe taxes on 90 percent of the rolled-over capital gains);
3. If investors hold for seven years, the basis increases by an additional 5 percent (meaning they will only owe taxes on 85 percent of the rolled-over capital gains). However, investors must recognize their original tax bill by December 31, 2026 at the latest, or until they sell their Opportunity Fund investments, if earlier; and
4. Investors may exclude new capital gains on Opportunity Fund investments held for at least 10 years from taxable income. In other words, after settling their original tax bill, patient investors in Opportunity Funds will not have capital gains taxes on their Opportunity Fund investments.

Opportunity Fund investments must be made in: (a) stock in a domestic corporation; (b) capital or profits interest in a domestic partnership; or (c) tangible property used in a trade of business of the Opportunity Fund that substantially improves the property. Opportunity Funds are prohibited from investing in federally defined "sin" businesses (e.g., racetrack or gambling facilities, liquor stores, massage parlors, etc.), but beyond those prohibitions, everything else is fair game.

It is important to understand that this incentive is not funded through any appropriations mechanism and is not a government "program." This is a *tax* incentive, delivered in the form of a "special treatment" of capital gains, to encourage private investors to invest private capital. The distinction is an important one: a "program" tends to carry structural guardrails, such as meaningful reporting, transparency and accountability mechanisms; a tax incentive can be far less structured, as is the case with Opportunity Zones.

Opportunity for Whom?

With this remarkably flexible new tool available, many people are asking how Opportunity Zones can be used to address problems in their community. We believe the answer lies in understanding the needs of low-income communities and the types of capital needed to address the roots of economic inequality. We also believe it's crucial to understand the nature of capital flows and how this incentive may change those flows to the benefit or detriment of the communities it is designed to serve.

It is a well-established principal that, holding all things constant, capital will flow to the highest-return, lowest-risk, lowest-friction environment. This means that capital seeks to maximize return while simultaneously reducing risk. The tension between risk taking and economic return leads to what is known as a "market-rate" return in which the capital markets, under ever-fluctuating conditions, agree that a given rate of return is acceptable for a given amount of risk. This market-rate return also is influenced by the friction involved in facilitating the investment. Investments that are simple to execute and monitor are considered low friction. Investments that are complex, time consuming, heavily regulated, and lacking transparency are high friction and typically require a higher rate of return to compensate investors for that friction.

The trouble is, the market has never been particularly good at valuing the risk/return profile of low-income communities because of an inherent bias, the roots of which lie largely in racism and discrimination. Our modern financial markets, designed in a historical and societal context, have systematically oppressed poor people—specifically, people of color—since the founding of this country. Today, looking at overall patterns of asset allocation in our economy, it is not difficult to spot the inherent prejudice of the capital markets: Of the $71.4 trillion in assets

under management today, black owned/managed funds account for only 1.1 percent.[5] This essay is not a treatise on the history of oppressive capital markets, but that is the unavoidable cornerstone upon which this essay is founded. Without that knowledge and understanding, we cannot hope to address growing economic inequality using this new tool or any other. It is within this history and contemporary reality, therefore, that we analyze how Opportunity Zones can help address inequality and promote more equitable and inclusive mixed-income communities.

Our collective years of experience and a mountain of research tell us that thriving communities are mixed-income communities[6]—and that mixed-income communities require a variety of housing opportunities that not only serve households of varied incomes but also acknowledge and honor the historical and cultural norms within a given community. These exemplar communities offer adequate access to transit, employment, health care, and healthy foods. They possess high-quality schools that are accessible to their residents, and they tend to be more racially diverse than other communities.[7]

The financial tools needed to construct and maintain these communities include traditional debt tools, such as single-family mortgages, commercial real estate financing, small business loans, and equity investments. Equity, the scarcest of these tools, is ownership. It is the risk capital contributed by an owner, which is used to protect the lender and establish the means by which to distribute profits from a business or the appreciation of the asset. Equity typically is sourced from an individual's own savings, friends and family, or institutional players such as private equity funds. It is viewed as higher-risk/higher-return capital and thus more difficult to source. In low-income communities, the sources of equity we have outlined rarely, if ever, exist; businesses that start up in these communities tend to require lower-cost, more flexible and patient capital.

Business owners in low-income communities are often low-income themselves, with little access to saving. Their friends and families also tend to be low-income with limited resources. Institutional players rarely invest capital in these places—whether due to prevailing biases and an undue perception of risk or to other reasons.

Real estate projects in low-income areas, which typically have very limited budgets and are designed to build primarily affordable housing, often obtain equity from federal programs, such as the Low-Income Housing Tax Credit (LIHTC). These programs are dramatically

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[5] Editors' Note: We have recommended that essay authors use the term "African American" when referring specifically to descendants of enslaved people in the United States and the more inclusive term "black" when referring broadly to members of the African diaspora, including African Americans, Caribbean Americans, and Africans. In this way, we seek to acknowledge the unique history and experience of descendants of enslaved people in the United States and also the diversity of backgrounds within the larger black community.
[6] Raj Chetty, Nathaniel Hendren, and Lawrence F. Katz, "The Effects of Exposure to Better Neighborhoods on Children: New Evidence from the Moving to Opportunity Experiment," *American Economic Review* 106, no. 4 (2016): 855-902.
[7] Ludwig et al., "Long-Term Neighborhood Effects on Low-Income Families: Evidence from Moving to Opportunity" (working paper, National Bureau of Economic Research, Cambridge, MA, February 2013).

oversubscribed and typically cap the amount of economic return available to investors, effectively pushing out market-rate capital. Furthermore, these tools often make financing mixed-income and mixed-use developments far more complicated; LIHTC income limits make it difficult to produce affordable units for middle-income households, so investor interest in mixed-income and mixed-use development diminishes.

Opportunity Zones would seem an ideal tool to remedy the challenges of real estate investing and to deliver the type of capital most needed for projects in low-income areas. The incentive provides a substantial tax break for investors; therefore, in theory, the investor should be willing to take a lower before-tax "market rate" of return. In addition, the investor is increasingly rewarded for being patient and keeping the capital invested. And there are few regulations to limit the types of investment allowed, which maximizes this tool's flexibility. Nonetheless, there are reasons for concern.

The Opportunity Zone incentive was not really designed for investment in real estate. The authors of the bill believed that the lack of equity capital in low-income communities was hindering the creation of new businesses and the growth of existing ones, and they thought the OZ market would consist largely of private equity and venture capital firms investing in new and growing businesses. If business owners could access the equity they need, they could grow, hire more people to work within the neighborhoods, and pay higher wages, which would indirectly reduce the economic disparity in a given census tract.

However, real estate has now become the dominant form of Opportunity Zone investments. According to Novogradac, as of December 2019, 74 percent of known Opportunity Funds were investing some portion of their funds into real estate and 69 percent of reporting funds were investing *exclusively* in real estate, while only 3.2 percent of reporting funds were investing exclusively in operating businesses. This is largely due to the way the incentive's regulations were issued, and also because real estate provides the lowest-friction environment for OZ investment. The incentive's rules require a certain percentage of the Opportunity Funds' assets be held in a specific geography, referred to as the Opportunity Zone. But as businesses grow and hire people, they tend to open new facilities in other geographies as they follow their customers. By contrast, real estate does not move. Removing that friction alone is likely to keep tilting OZ investment toward real estate for the foreseeable future.

The focus on real estate may present both an opportunity and threat for the community development field. If harnessed correctly, it could bring untold amounts of desperately needed equity to our sector. If left unchecked, there is a significant chance the incentive could greatly exacerbate the problems of gentrification and displacement plaguing some communities. In addition, it's possible this new capital will simply follow the old channels flowing largely to costal urban centers, again leaving behind the Rust Belt and rural communities.

Some of these concerns seem already to be coming true. In March 2019, Zillow issued a report studying the increase in land value across Opportunity Zone census tracts, census tracts

eligible but not selected for OZ designation, and non-eligible tracts. Sales price for Opportunity Zone properties increased by more than 20 percent year-over-year after the selection of the Opportunity Zones.[8] By comparison, properties in census tracts that were eligible but not selected rose by only 8.4 percent. While many factors could explain this rise and disparity, it's a powerful datapoint and it suggests that investors are seeing the value in investing in low-income communities. However, this run-up in value appears to be happening only in large metro markets, including gentrifying neighborhoods in cities such as Oakland, Portland, and New York, which were on an upward trajectory to begin with and did not need tax-advantaged capital.

For low-income people, this type of rapid appreciation in real estate values is a mixed bag, at best. The value of their homes may be rising, creating new sources of equity (assuming they own their homes). In addition, multifamily affordable housing projects that already have land control may be able to access additional financing at more attractive rates because of the increased value of their collateral. However, projects that have not yet acquired land in an Opportunity Zone, and renters already living in these communities, are likely to experience significant additional burdens due to rising land values. The OZ incentive creates a new and powerful motivation for land owners in low-income census tracts to maximize profits. The greater the profit maximization, the greater the equity invested in Opportunity Funds will appreciate, which will greatly enhance their rewards. The problem is that affordable housing and mixed-use developments typically offer lower overall capital appreciation, making them less compelling than they were before the incentive was created.

Early Lessons and Potential Models of Impact

With these headwinds in mind, there is still hope in turning the incentive toward serving low-income communities' needs. A relatively small but committed group of fund managers across the country are providing a glimpse of Opportunity Zones' potential in distinctly different ways, delivering both a healthy economic return as well as real and quantifiable positive community impact. For example:

- Renaissance Equity Partners, LLC ("Renaissance") is raising a nationwide Opportunity Zone fund focused on supporting development in partnership with historically black colleges and universities (HBCUs). The fund seeks to partner with HBCUs as anchor institutions that drive significant economic activity in their respective markets. These institutions frequently possess excess land; they also generate demand for retail commercial offerings and housing on and around their campuses. However, the traditional capital markets and the development community often overlook or dismiss HBCUs, often because of racial biases. Renaissance sees a market opportunity in

[8] Alexander Casey, "Sale Prices Surge in Neighborhoods With New Tax Break," *Zillow*, March 18, 2019, https://www.zillow.com/research/prices-surge-opportunity-zones-23393/.

providing much-needed retail and housing amenities to the students and employees of HBCUs and also in partnering with these institutions to diversify their revenue streams. (Beyond its direct impact, Renaissance is one of the very few Opportunity Zone funds owned and managed by a person of color.)

- Enterprise Community Investment's OZ efforts center on mixed-use, mixed-income investment strategies in varying types of communities—from densely urban, gentrifying neighborhoods where affordable housing is increasingly scarce to smaller, lesser-known towns where more comprehensive redevelopment efforts are called for.

Based on Enterprise's experience so far, several realities have become clear in the early days of Opportunity Zones. First, we are indeed observing a place-based bias on the part of investors: Investors appear reticent to put their OZ capital into non-urban cores and small cities proximate to larger metro markets, preferring instead to invest in larger metro regions such as Los Angeles, CA. This is partly to be expected, but we believe there is still an irrational bias at play here. Smaller but dynamic towns like Greenville, SC represent a promising model of economic revitalization. These towns respond to the shifting preferences and geographic dynamics of the American landscape by offering the opportunity richness and clustering benefits of an urban environment while remaining more affordable to residents and businesses and within reach of people who historically have been disconnected from opportunity. According to researchers like Ross DeVol, midsized and even smaller cities ("micropolitans") can be a key to rural resurgence.[9] The investor bias toward major markets is especially unfortunate because Opportunity Zones offer, at least in theory, a unique chance to address the geographic inequality of opportunity that researcher Raj Chetty's profound work has laid painfully bare.

A second early takeaway is that the structure of Opportunity Zones limits the type of impact that is feasible. Deeply affordable housing, for example, is more difficult for OZ equity to produce, given the lower cashflow and inherent ceiling on potential capital appreciation in affordable housing. This limits the potential scalability of affordable housing developments that would serve lower-income residents, such as those earning below 60 percent of the Area Median Income (AMI). At the time of this writing, officials in the U.S. Treasury Department are considering how they might better structure the incentives to enable pairing of Opportunity Zones investments with Low-Income Housing Tax Credits; for the moment, however, Opportunity Zones are not an especially viable tool for creating deeply affordable housing, at least not without some measure of additional subsidy.

[9] Ross DeVol and Shelly J. Wisecarver, *Micropolitan Success Stories from the Heartland*. (Bentonville, AR: Walton Family Foundation, 2018), https://8ce82b94a8c4fdc3ea6d-b1d233e3bc3cb10858bea65ff05e18f2.ssl.cf2.rackcdn.com/d7/f9/00e59918410b83b3a3471533dd44/micropolitan-success-stories-report-print-updated-5.11.2018.pdf.

Within this constraint, however, also lies opportunity. Many people in the community development space increasingly lament the scarcity of “workforce” housing options for moderate-income households—those that earn too much to qualify for most subsidized low-income housing but too little to afford market-rate options (often found in the 80 to 100 percent range of AMI). This segment of the population might include teachers, government workers, firefighters, artists—in short, those who contribute to the community but are getting squeezed out of neighborhoods by housing market pressures. Enterprise’s OZ efforts thus far are demonstrating that mixed-income developments that integrate market-rate rents with workforce rents are economically feasible, as the cashflow from the market-rate rents serves to goose up the project’s overall return profile (particularly after factoring in the OZ tax benefit). In many cases, through this mixed-income strategy we are also able to work with developers to achieve more deeply affordable rents (namely, those targeted for households below 60 percent of AMI) for a project’s non-market-rate units. Again, by sheer virtue of the numbers, this strategy allows for only so many additional affordable or workforce units to be built, which likely means it will be difficult to scale up in ways that produce a broad impact. However, we believe that there is unique value in this mixed-income approach.

Conclusions

As we have suggested, thriving communities are in fact mixed-income communities, places where diverse housing options meet the diversity of housing needs. A strategy centered around mixed-income housing developments not only serves to relieve housing pressures in a community, which tends to have positive spillover effects for everyone, but also fosters greater *integration* of households from different income bands, which we know is critical for inclusive growth and economic mobility for lower-income residents. That, of course, is the spirit behind Opportunity Zones.

Despite the glimpses of potential benefits represented in the examples we have featured, however, an untold number of Opportunity Zone funds currently being formed are decidedly *not* impact-oriented. And, given the current lax regulatory framework, there is reason to be concerned that more will follow. While we believe that the fate of Opportunity Zones is neither inevitably good nor inevitably bad, we do think we are at an important juncture and it is still within our collective power to shape the tool as a force for good. To ensure that Opportunity Zones serve to narrow the wealth inequality gap rather than exacerbate it, all of us—policymakers, philanthropists, researchers, developers, investors, and residents themselves—have crucial roles to play.

Implications for Action

Implications for Policy.

- Federal officials must address the shortcomings of the Opportunity Zones legislation, a law that was remarkably thin on details and guardrails. While there are many issues to address, perhaps none is more important than the need to improve transparency through more robust reporting requirements. Currently, investors are required to report very little on their Opportunity Zone investments to the Internal Revenue Service. This leaves lawmakers, researchers, and community representatives with inadequate information to judge the efficacy of the tax incentive.
- Local policymakers need to engage with community groups to understand the nature and scale of capital needed to support local priorities. Based on that feedback and understanding, policymakers should craft strategies that support local objectives, simultaneously keeping in mind the needs of fund managers and investors. They can use any number of policy levers at their disposal, such as fast-track zoning, permitting, and entitlement processes, for projects that support community priorities.
- When a community identifies threats to its priorities, local government can and should exercise greater scrutiny. For example, if an affordable housing development project in an Opportunity Zone that is receiving tax abatement changes hands, the municipality should require disclosure of OZ-motivated capital. The municipality also should require additional due diligence, including an affordability study and enhanced plan review, before approving any continuance of abatement or new entitlement. This approach can be expanded across the toolset of state and local government, which can fill much of the vacuum left by the federal government's lack of robust reporting requirements.

Implications for Research and Evaluation.

- Researchers can evaluate the short- and long-term impact of the OZ incentive by comparing investments and outcomes in those places selected as Opportunity Zones with places that met the same criteria but were not chosen to participate.[10] Successful implementation of this recommendation will require more robust reporting requirements for investor, so that researchers have the data needed for evaluation.

Implications for Development and Investment.

- Investors must question the basis on which they have historically determined that certain communities, especially those that are home to low-income individuals and people of color, are higher-risk than they actually are. Senator Booker has referred to Opportunity Zones as "domestic emerging markets," suggesting that these long-overlooked communities are a new frontier of high-potential returns for investors who

[10] The Opportunity Zone designation process generally allowed for no more than 25 percent of a state's low-income census tracts to be designated.

are brave enough to jettison old modes. We agree that investors who look at Opportunity Zones through a new lens may be rewarded with high-return, high-impact opportunities.

Implications for Residents and Community Members.

- With Opportunity Zones, communities have new impetus to examine themselves not from a deficit perspective (*here is what missing and what we need*) but with an asset mindset (*here is what we have got and why you should invest in us*). Communities should seize this opportunity to identify their assets and investable opportunities.

A SPECIAL NOTE ABOUT PHILANTHROPY

Philanthropy is well-positioned to play an important, but precarious, role in the Opportunity Zone marketplace. Private philanthropy has deep knowledge and expertise in the community development finance sector, having funded the system since its inception. The Ford Foundation, The John D. and Catherine T. McArthur Foundation, the Rockefeller Foundation, the W.K. Kellogg Foundation, and many others have substantially contributed to some of the sector's most important and powerful innovations, including the Low-Income Housing Tax Credit and the New Markets Tax Credit; the , Rental Assistance Demonstration, and Housing Choice Voucher programs; and the Community Development Financial Institutions Fund, among others. That expertise is still relevant today.

It is philanthropy's obligation to empower the organizations already operating in the community development finance space and trust their judgment. These organizations know the capital needs of the communities they serve and what it will take to make Opportunity Zones address those needs. Few of our community development finance partners have substantial experience managing true equity products outside of federal tax credit programs, which are substantially different from OZs. These organizations need funding for training, technical expertise, fundraising, and the like. To begin filling this gap, The Kresge Foundation partnered with the Rockefeller Foundation, Calvert Impact Capital, Plante Moran, and Holland and Knight in creating an emerging Opportunity Fund Manager incubator.

Philanthropy's next obligation is to think local. There is very little federal oversight over this private tax incentive and virtually no guardrails preventing practices that could greatly harm the communities we serve. The legislation gave state governors the opportunity and obligation to designate Opportunity Zones on a relatively tight timeline, which created an impression of state or even local control over the incentive. However, many communities are now waking up to the fact that unless an Opportunity Fund voluntarily identifies itself, no state, mayor, city council, or resident will ever know what Opportunity Fund invested in its community, where it got its money from, and what it invested in. Maybe that won't matter to a policymaker or resident, as there are other local controls that exist to ensure community benefit; but maybe it will. Looking to the work of the Rockefeller Foundation and the Annie E. Casey Foundation, we see examples of how foundations can help equip local government leaders to understand the incentive better and to create strategies that allow cities to play both offense and defense in the face of a changing landscape.

Philanthropy must remain vigilant about demanding transparency and accountability. It's impossible to know how OZ designation will affect a community over time without being able to identify the players and their incentives. Private-market investment strategies, particularly those that lack transparency and accountability, have traditionally not been good for low-income communities. We need only look back to the recent financial crisis to see how the far more regulated and transparent derivatives market and sub-prime mortgage market decimated low-income communities, especially those of color, across the country. The crisis was preceded by many anecdotes of how loosening credit standards brought home ownership and wealth building to millions of Americans; as the Great Recession began, there were just as many stories of how the market destroyed generations of wealth and devastated communities. That is where we find ourselves today: evaluating by anecdote. For every Opportunity Zone cheerleader claiming this incentive will transform low-income communities for the better, there is a detractor claiming the opposite. To some extent, proponents of the current legislation have resisted requiring fund managers to publicly disclose their investors, amounts invested, fund investments, dispositions, and certain social outcome metrics, fearing this could dampen investor appetite and reduce the overall size of the market. That may be true. But philanthropy needs to ask itself: "Whom do we serve?" The answer should be obvious: A smaller, more transparent market that aligns with community needs is far better than a large, investor-friendly market with little transparency. Philanthropy must resist the seduction of phrases like "trillion-dollar market" and "investing at scale." Experience has taught us that while the amount of capital matters, the type of capital matters more. Without full transparency in the market, we face the very real risk of becoming a primary driver of many of the social harms we all seek to address. In the absence of full transparency, philanthropy should be extremely cautious about endorsing Opportunity Zones. And in the absence of proof, philanthropy should default to skepticism about whether this incentive, overall, will truly serve the needs of low-income communities.

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