The Biggest Problem With Opportunity Zones

The incentive program promised to help underserved communities. Instead, its tax breaks have disproportionately benefited wealthy investors, a new study finds.

By Alex Wittenberg
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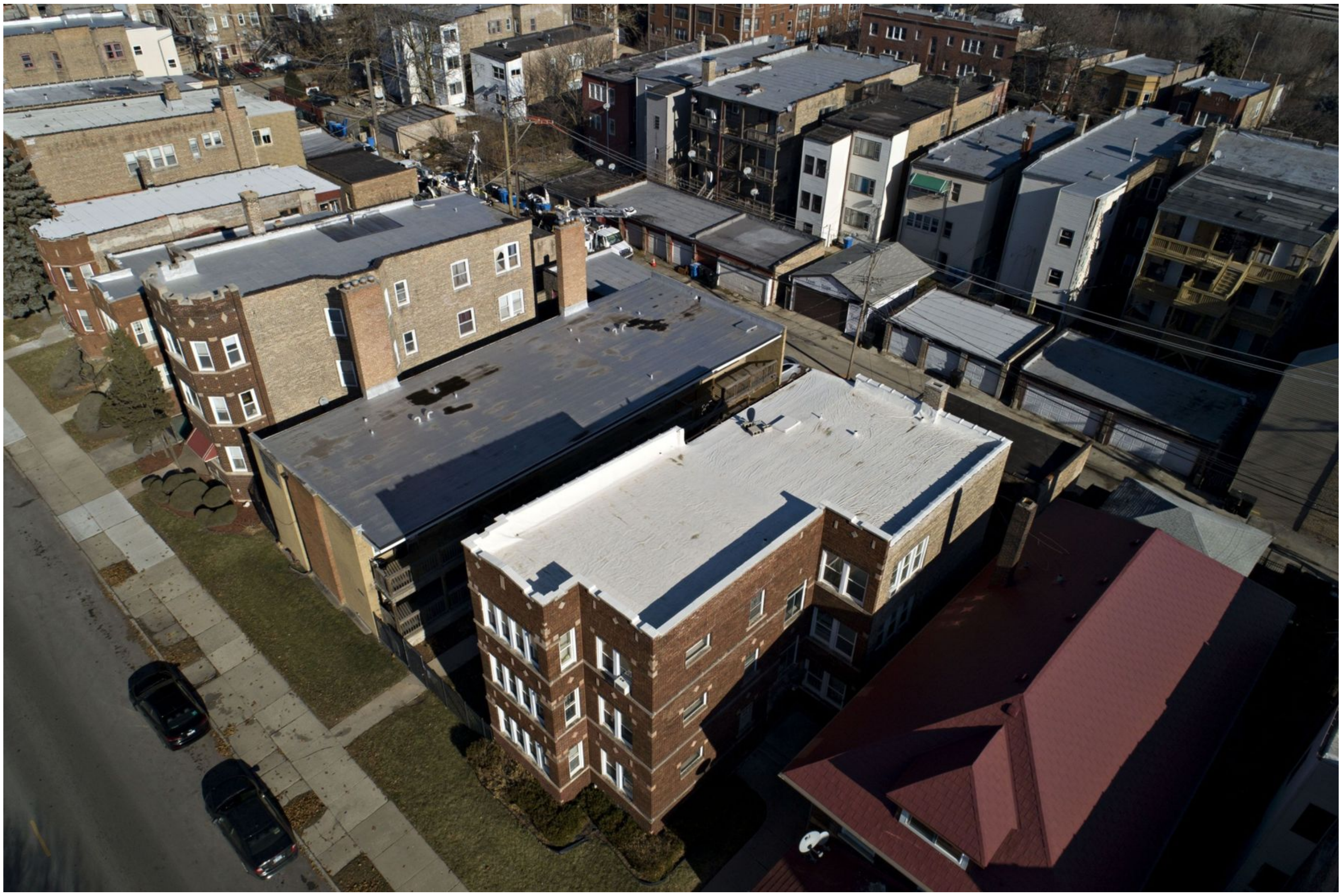

A Chicago neighborhood that's part of a federally designated Opportunity Zone. The tax-incentive program has been widely criticized as ineffective — and for good reason, a new study finds. *Photographer: Daniel Acker/Bloomberg*

Two years ago, when the U.S. Treasury Department outlined how its new "Opportunity Zones" program would work, many experts were skeptical. Touted as a tax incentive designed to spur investment in low-income communities and help remedy the unequal pace of regional economic development, the program looked to some like another tax break for the wealthy; others feared it would just underwrite big projects in gentrifying neighborhoods rather than lift up disinvested ones.

A new study by the Urban Institute offers more evidence that those skeptics had good reason to doubt the policy's promises. Most investment under the program had gone to large real estate

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projects instead of the small businesses and community developments that it was supposedly designed to support. Only a small percentage of the more than $10 billion invested as part of the program has benefited existing businesses, the study concluded: “It appears that [Opportunity Zones] are neither on a trajectory to democratize access to capital nor will they, at scale, incentivize mission-oriented projects that align with community goals and priorities.”

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The Opportunity Zones (OZ) program, a bipartisan measure of the tax reform bill passed in 2017, allows investors to secure a tax break on capital gains by putting their returns in funds that provide equity investments to projects in areas that the government defines as “economically distressed.” Across the country, 8,766 urban, rural and suburban census tracts have been so designated. The investor’s capital gains tax is gradually reduced as the investment is held over time. If the money stays in a project for at least 10 years, the tax is exempted entirely. About 94% of taxable capital gains in the U.S. come from households with incomes above $100,000, according to the study, and only 12% of OZ residents have household incomes beyond that threshold.

That discrepancy highlights one of the issues with the program, the researchers wrote. The Urban Institute study – which drew on about 70 interviews with developers, project sponsors, fund managers, nonprofits and others stakeholders in OZ projects – concludes that the main beneficiaries of the incentive have been wealthy investors, not residents of the distressed communities. The few Opportunity Zone residents who have capital gains would be hard pressed to defer investments seven or 10 years. “You’ve got to have a lot of gains to not need them for 10 years, so we’re really talking about something that’s attractive to the 1%,” said Brett Theodos, a senior fellow at the Urban Institute and one of the study’s lead researchers.

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> “We have an incentive that doesn’t incentivize impact.”

Perhaps the bigger problem has to do with returns, the researchers wrote. Like anyone else, wealthy investors expect a return on their investment, something affordable housing and community businesses typically can’t provide at the same level as a big real estate project. One Florida-based affordable housing developer quoted in the study said investors expected market-rate returns from their project, “something we can’t produce in affordable housing.” Many mission-driven projects had projected returns between 3% and 7% compared to a market-rate expectation of 12% to 16%, according to the study.

The natural incentive to get the highest return along with the risk that a 10-year investment entails means few investors have been attracted to projects that would specifically benefit struggling communities, said Theodos, who thinks the program should be revised so that returns are determined by the social impact of the project. “We have an incentive that doesn’t incentivize impact,” he said.

While addressing racial inequity was a key program goal, Black leaders of OZ projects have faced discrimination from potential investors, the study reported. One developer of color trying to build green workforce housing in the Midwest told the researchers that wealthy investors had closed their doors to minority developers. Some Black business leaders have had a more positive experience with the program, according to the study, requesting funds for projects like mixed-use buildings near historically black colleges and universities and a workforce development center in Chicago.

In recent months, the coronavirus pandemic has also blunted the program’s impact. A new study by the Economic Innovation Group that surveyed more than 100 developers and others involved in OZ projects found that 52% said the pandemic had a “negative impact” on their plans. Some 71% of potential investors said they were hesitant to commit because of the uncertainty. On June 4, the IRS extended the deadline for qualified OZ investments to the end of December in response to the pandemic’s effects; two weeks later, at his rally in Tulsa, President Donald Trump claimed without evidence that $100 billion had been invested in OZs. The White House is currently mulling ways to extend the program.

Still, the Urban Institute report holds out the possibility that Opportunity Zones may yet have promise. The program could be retooled to better reward investments in small businesses and projects that actually benefit struggling communities by permitting the use of debt instruments instead of equity alone. The authors also recommend allowing the program to encourage investments in community development financial institutions, which offer loans to small businesses in underserved areas. “There will absolutely be pressure on Congress to extend Opportunity Zones,” Theodos said. “To extend the incentive, it will need to become much more beneficial for communities than it is right now.”

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