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Harnessing the Capital From Opportunity Zones Toward Equitable Development Goals

A preliminary overview of the challenges and planning needed for opportunity zones to make a positive impact

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The Tax Cuts and Job Creation Act (HR 1) passed in December 2017 includes provisions that establish Opportunity Zones. The goal of these zones is to drive private, long-term capital to distressed census tracts by providing investors with tax breaks on capital gains. The tax breaks would depend on the length of time that taxpayers are willing to hold their capital gains in specially created Opportunity Funds, which target these chosen Opportunity Zones.[1]

The temporary deferral of capital gains — and even permanent exclusion from taxation — is a tax break that erodes the federal tax base; therefore, it should be highly monitored to ensure that a public return is achieved. An estimated $2.2 trillion in unrealized capital gains are currently held by individuals and companies.[2] Estimates of the potential dollars at play from North Carolina taxpayers alone are roughly $936.6 million each year. [3]

Given the lack of conclusive evidence around the connection with tax-based incentives and improved economic outcomes and the real trade-offs that are required with public investments in education, housing and community infrastructure with the loss of revenue, the ultimate outcomes of these policies remain unclear.

There have been various other public policies that have sought to drive private capital to communities with low incomes or to revitalize these communities, and experience shows that the design of the program and the attention of communities to potential negative effects upfront is critical to minimize the harm and maximize the benefits. The process of implementing the Opportunity Zones program is primarily under the direction of the U.S. Treasury, which has certified census tracts selected by states and will establish rules for the program, including certification of the newly formed Opportunity Funds. States had the opportunity to intervene in the federal program only through selection of the census tracts and public comments to the Treasury, which will be issuing rules to guide the program's implementation.

1. Opportunity Zones. (n.d.). Retrieved May 28, 2018, from https://www.enterprisecommunity.org/policy-and-advocacy/policy-priorities/opportunity-zones-program
2. Reilly, R. (2018, February 8). Breaking Down the Benefits of Investing in the Opportunity Zones Program. Retrieved June 23, 2018, from https://www.enterprisecommunity.org/blog/2018/02/benefits-opportunity-zones-program
3. Special Data Request, July 2018, Institute on Taxation and Economic Policy.

This BTC report provides an overview of what is currently known about the Opportunity Zones and provides a preliminary analysis of the Opportunity Zones selected in North Carolina. As well, directions for future work are identified to ensure that the benefits to existing residents in Opportunity Zones are realized.

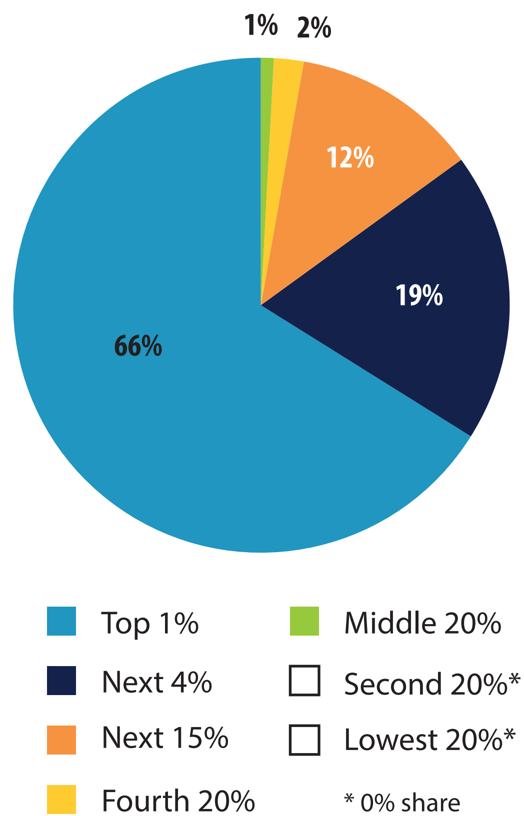
An overview of the Opportunity Zones

Eligible census tracts are U.S. Census-defined geographies where the poverty rate is 20 percent or greater or where family income is lower than 80 percent of the area's median income. States could select 25 percent of their qualifying census tracts, including a certain portion that were contiguous (shared a common border) in order to support effective administration of the program. In North Carolina, 1,096 low-income census tracts and eight contiguous tracts — 1,433 in total — that met the criteria were eligible. Out of the 1,433 tracts, 252 census tracts were nominated by Governor Roy Cooper and have been certified by the Treasury as designated Opportunity Zones.

It appears that capital could start flowing as early as the fourth quarter 2018 or early 2019. In order for investors to take full advantage from the seven-year tax deferral, the program needs to be operational by December 2019.

Capital gains, which are profits from the sale of an asset — such as stocks, bonds, investment or vacation real estate, art, or antiques — are not taxed until the asset is sold. The capital gain is the difference between the selling price and the original purchase price for the asset. Through the Opportunity Zones program, taxpayers with capital gains can elect to place those gains into Opportunity Funds and receive the following tax breaks.

Figure 1: Capital-gains tax break to benefit the wealthiest North Carolinians.



Source: Special data request to Institute on Taxation and Economic Policy, July 2018

- Tax deferral: Investors can defer paying federal taxes owed on their capital gains if they invest the money in an Opportunity Fund within 180 days. Taxes will still be due, but not until the end of the Opportunity Zone program — Dec. 31, 2026 — or earlier if the original investment is sold or otherwise taken out of the fund.
- Reduction on deferred taxes of original investment: 10 to 15 percent of federal taxes that would be otherwise due is canceled as long as 90 percent of the money is left in the fund for a set number of years to support properties and businesses within the Opportunity Zones.
- A permanent exclusion from taxable income of capital gains: From the sale or exchange of an investment in a qualified Opportunity Zone Fund, if the investment is held for at least 10 years. (Note: This exclusion applies to the gains accrued from an investment in an Opportunity Fund, not the original gains.) Capital gains are highly concentrated among the wealthiest of wealthy taxpayers. In North Carolina, just 8 percent of taxpayers pay capital-gains tax in a given year. The Institute on Taxation and Economic Policy estimates that the top 1 percent of taxpayers in North Carolina, whose average income is $1.3 million, hold 66 percent of the state's capital gains (See Figure 1).[4]

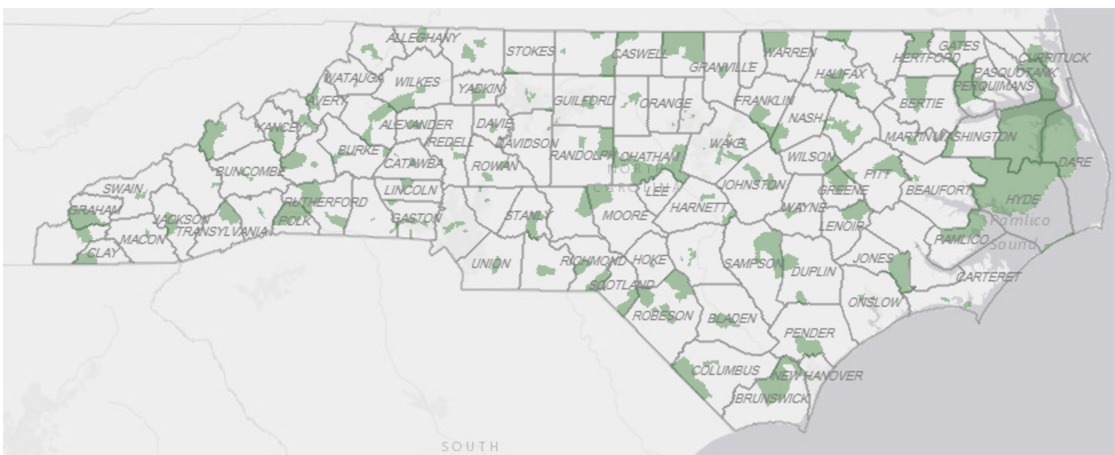
4. Special Data Request to Institute on Taxation and Economic Policy, July 2018.

Opportunity Funds (O-Funds) have to be set up to hold the capital gains of taxpayers. Current guidance in statute is that they only have to be organizations or partnerships that are formulated to direct Opportunity Funds into Opportunity Zones. National groups have interpreted this to include institutional investors and investment banks, impact investors, Community Development Financial Institutions (CDFI), community foundations and philanthropies as well as venture-capital partnerships. The Internal Revenue Service has additionally issued the guidance that Opportunity Funds can be self-certified by taxpayers, whether individuals or organizations. O-Funds will be certified by the U.S. Treasury and audited twice a year to ensure that they meet the required threshold. In order to receive tax relief, 90 percent of the assets must be invested in Opportunity Zones property.

North Carolina's Opportunity Zones

Out of the 2,195 census tracts that make up North Carolina, 1,433 eligible census tracts qualified as Opportunity Zones, but only 252 tracts were designated. The eligibility of more than half of all census tracts as potential Opportunity Zones points to the economic distress that communities are facing across the state. Out of the 252 designated tracts, 244 are low-income communities (LIC) and eight are contiguous tracts.[5] [6] The eligible but non-designated tracts were comprised of 329 contiguous census tracts and 852 LIC tracts.

Figure 2: Designated Opportunity Zones spread across North Carolina.



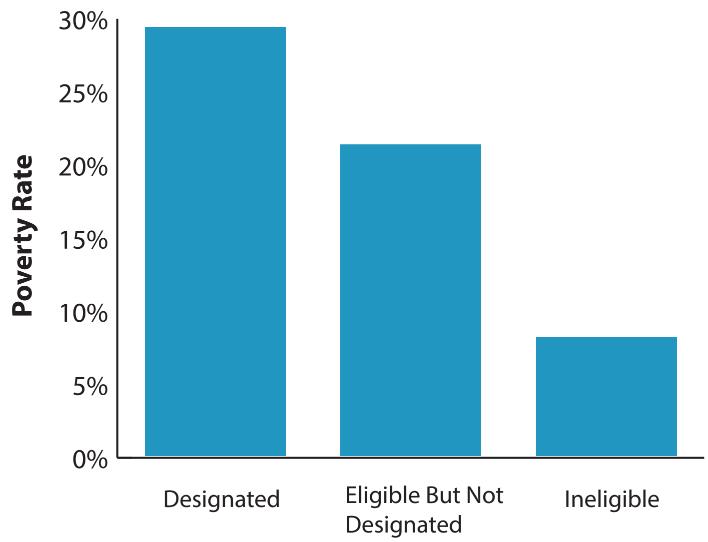
Source: Analysis of United States Census, American Community Survey, 2012-2016 five-year estimates.

Based on preliminary analysis, the designation of Opportunity Zones in North Carolina effectively focused on areas with higher poverty rates, lower median household income and greater concentrations of communities of color that have faced historic disinvestment. In so doing, the Opportunity Zone designation could drive better economic outcomes and address the barriers to investment that persist should private capital focus on increasing the incomes and lowering poverty rates for all existing residents of these communities. However, given the levels of homeownership and educational attainment in designated Opportunity Zones, there is a greater potential for displacement to occur should property values rise and jobs move into the area. It is therefore important that the implementation of Opportunity Zones and their associated funds carefully pursue equitable outcomes from this investment of private capital.

5. "Up to 5% of census tracts that do not meet the definition of a low-income community can be designated under a contiguous tracts exemption. Exempt tracts must be contiguous with low-income community census tracts that are designated as Opportunity Zones, and the median family income of the tract must not exceed 125% of the median family income of the designated low-income community census tract with which it is contiguous." NC Department of Commerce
6. Enterprise Community Partners, Opportunity Zones 360. (2018, February 28). Retrieved May 23, 2018, from Enterprise Community Partners, Opportunity Zones 360

Studies show that North Carolina, along with other Southern states and the Rust Belt, has lower economic mobility than the rest of the United States.[7, 8] In North Carolina, a child who grows up in a high-poverty community is less likely to progress up the economic ladder than a child who is born into poverty in a Northern or Western state. As the state tries to minimize the double burden of a poor neighborhood on children's lifelong earnings and mobility and to promote thriving communities for all residents, a focused public and private investment strategy in poor communities is needed.

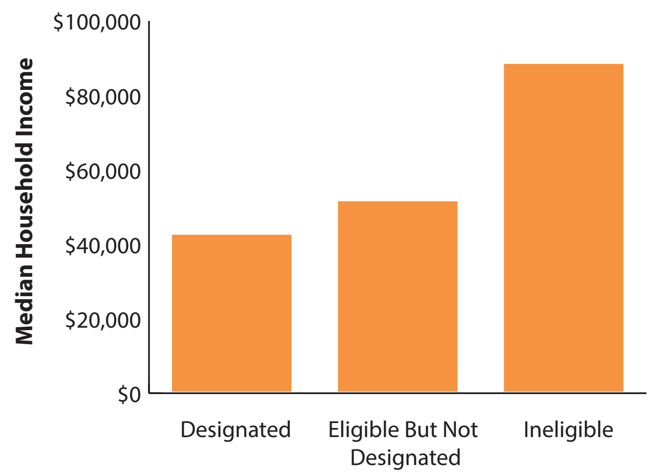
Figure 3: Poverty more prevalent in designated zones.



Source: Analysis of U.S. Census, American Community Survey, 2012-16 five-year estimates

As Figure 3 shows, the average poverty rate for designated census tracts is nearly 30 percent, while that of eligible but non-designated communities is just over 21 percent. The poverty rate in ineligible census tracts is 8 percent. The disparities in income and poverty among designated and ineligible tracts highlight the large and growing income inequality in North Carolina.[9 10]

Figure 4: Household income depressed in designated zones.



Source: Analysis of U.S. Census, American Community Survey, 2012-16 five-year estimates

As Figure 4 shows, the median household income level for designated census tracts was approximately $9,000 lower than median incomes in tracts that were eligible but not selected. The income divide is even more profound comparing designated to ineligible tracts, with ineligible tracts having a median household income nearly twice that of tracts that were selected for inclusion in the Opportunity Zone program.

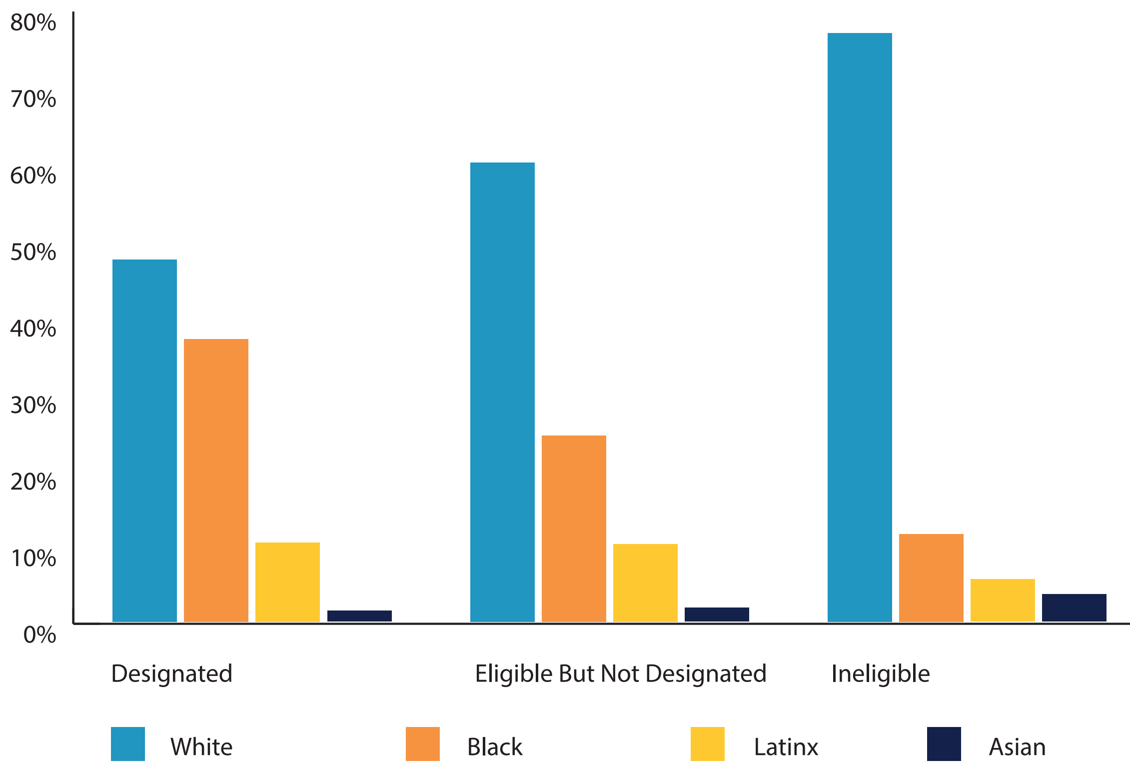
As segregation persists in our communities resulting from the legacy of legal segregation policies and the persistent policy choices that create barriers to the integration of communities across racial and ethnic lines, the barriers to economic opportunity and mobility are also maintained. The racial disparities that exist in North Carolina are highlighted by

7. Pew. (2012, May 10). Economic Mobility of the States. Retrieved June 25, 2018, from http://www.pewtrusts.org/en/research-and-analysis/data-visualizations/2012/economic-mobility-of-the-states.
8. Carter, P. C., & Spivakovsky-Gonzelz, P. (2014, June 14). Patterns of Economic Mobility in the United States (Rep.). Retrieved June 25, 2018, from Washington Center for Equitable Growth website: https://live-equitablegrowth.pantheonsite.io/wp-content/uploads/2014/06/061014-mobility-report.pdf
9. Sirota, A. (2016, December 20). North Carolina's high levels of income inequality no accident. Retrieved June 28, 2018, from http://pulse.ncpolicywatch.org/2016/12/20/north-carolinas-high-levels-income-inequality-no-accident/
10. Enterprise Community Partners, Analysis of U.S. Census Bureau Data, 2016 American Community Survey

the differences in household makeup in the different tract categories. [11]

The high concentration of Black communities in designated census tracts reflects decades of systemic racial barriers to opportunity and a lack of investment in communities of color across the state. At the same time, should the focus of investors be to drive equitable economic outcomes and projects that are proven to do so, there is the potential for the designation of these census tracts to address in small part the historic underinvestment in communities of color.

Figure 5: Communities of color more concentrated in designated zones.



Source: Analysis of U.S. Census, American Community Survey, 2012-16 five-year estimates

One missed opportunity for the state was the failure to address the barriers to capital that many rural communities face. A little over half of all census tracts in North Carolina are categorized as urban, while the rest are rural. Mirroring the state's composition, 61 percent of designated tracts are urban, and 39 percent are rural. In eligible but nondesignated tracts, 54 percent are urban, and 46 percent of tracts are rural. Many states have similarly designated tracts in more urban communities.

While the Governor's Office did pursue designation of at least one tract in every county, this approach is unlikely to lead to projects in every county, including those that are rural. The reality is that many rural projects may not be able to achieve the scale or return that national investors are seeking nor may they be able to engage with those who could help them connect to investors in the first place. An intentional focus on rural projects that can provide regional benefits and a layering of the investment of public dollars into infrastructure and technical assistance could ensure that the share of projects funded includes a more representative share of rural places in the state.

11. Enterprise Community Partners, Analysis of U.S. Census Bureau Data, 2016 American Community Survey

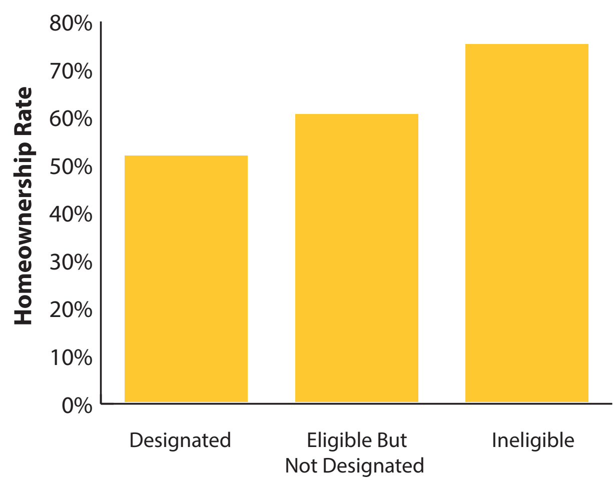
Risks of displacement in North Carolina Opportunity Zones are real

The benefit of driving private capital into communities with high need is to grow the number of places in our state that deliver a high quality of life to residents. Improving a community by displacing existing residents undermines that goal. Across the country, the potential risk of displacement from the Opportunity Zones designation is being estimated by looking at the level of homeownership and educational attainment. The assumption is that communities with more renters will have less ability to absorb the rising costs of rent associated with rising property values or to hold onto their rental contracts should landlords decide to sell. For those with lower educational attainment, the assumption is that jobs created in communities could require higher educational attainment, provide few opportunities for training at the outset, and instead import their workforce from other places.

These concerns are real in North Carolina where renters across the state are already cost-burdened and employment outcomes for those with less than a bachelor's degree are below that for those with a degree. Indeed, data show that nearly half of all renters are cost-burdened — meaning that they pay more than 30 percent of their income on rent.[12] High rental costs force individuals to choose between paying rent and paying for other basic necessities such as medicine, food, and transportation.[13]

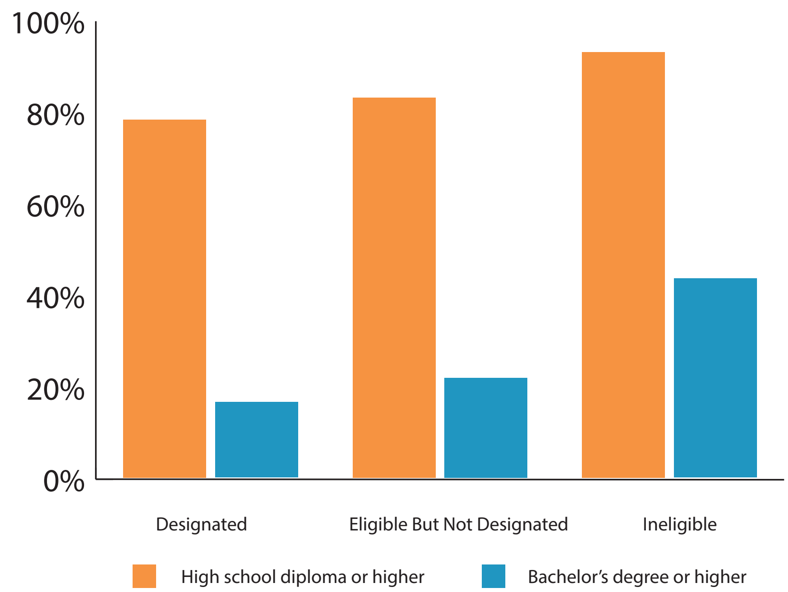
Figure 6 shows the homeownership gap between designated Opportunity Zones and other census tracts. The homeownership rate in ineligible communities is 75 percent, while only 50 percent of residents in designated tracts own their homes.

Figure 6: Homeownership less common in designated zones.



Source: Analysis of U.S. Census, American Community Survey

Figure 7: Educational attainment lower in designated zones.



Source: Analysis of U.S. Census, American Community Survey, 2012-16 five-year estimates

12. The Joint Center for Housing Studies, Harvard University. (2016). Renter Cost Burdens, States. Retrieved from http://www.jchs.harvard.edu/ARH_2017_cost_burdens_by_state_total
13. Aurand, Ph.D, A., Emmanuel, D., Yentel, D., & Errico, E. (2017, March). The Gap: A Shortage of Affordable Homes(Rep.). Retrieved June 25, 2018, from National Low Income Housing Coalition website: http://nlihc.org/sites/default/files/Gap-Report_2017.pdf

Figure 7 shows that in ineligible census tracts where the poverty rate is just 8 percent, the average percent of households that have a high school diploma or higher is 92 percent, and 43 percent of households have a bachelor's degree or higher. In contrast, the average number of households with a high school diploma or higher in eligible but not designated tracts is 83 percent, and the number of households on average that have a bachelor's degree or higher is approximately 22 percent. In designated Opportunity Zone tracts, which have an average poverty rate of nearly 30 percent, the average percentage of households that have a high school diploma or higher is 78 percent, while only 16 percent — one in nearly six people —have a bachelor's degree or higher.

The promises and potential pitfalls of Opportunity Zones

The Opportunity Zones program is intended to drive private capital into distressed communities across the United States. Given the research on what works to drive private capital to achieve public good, there remain questions about whether the kind of capital that Opportunity Funds will attract is best suited to effectively improve outcomes for existing residents. Moreover, whether North Carolina communities will see any of the national dollars for projects in North Carolina Opportunity Zones remains a question.

Research shows that private capital is sought out as a solution to ameliorate societal and environmental challenges, especially when fiscal constraints exist, because it has the potential to boost public dollars.[14] However, while private capital investments can address these issues, the investment of private capital is driven by the expectation of high returns, not improved outcomes. As a result, private capital investments can negatively affect an area if community impact is disregarded or deprioritized when an investment is made. If the goal of a private capital investment is to positively impact a community, the investment must be planned in conjunction with key actors in the community.[15]

Research shows no evidence that a low capital-gains tax bolsters the stock market, investment, or the economy. Moreover, there are real concerns that private capital is ill-equipped to drive better economic outcomes for those living in poverty or near poverty.

Investors who direct money toward Opportunity Funds will receive tax breaks before there is a return on their Zone investment.[16] This may drive investors to places where property prices are already rising, speed up gentrification, which occurs when lower-income residents of a neighborhood or area are displaced by an influx of by higher income individuals due to rising real-estate costs, and increase the likelihood of displacement for low-income residents.[17] The lack of incentives to draw investment to each designated zone may also disproportionately benefit urban zones. This would widen the already existing opportunity gap between urban and rural areas of the state. The lack of accountability in the program — there are few rules that specify how funds can be used — is the primary downfall of the program. Without accountability, matching the investments to the needs of designated tracts is less likely to occur. [18]

To maximize the potential of Opportunity Zones for North Carolina, communities, advocates, and policy-makers should consider:

- Comprehensive community plans with input from stakeholders and residents.
- State and local brokers to connect projects that consider equity and inclusion with investors.
- Mission-driven institutions like community foundations and CDFIs as managers of

14. Sabol, P., & Puentes, R. (2014, December). Private Capital, Public Good: Drivers of Successful Infrastructure Public-Private Partnerships(Rep.). Retrieved July 2, 2018, from Brookings website: https://www.brookings.edu/wp-content/uploads/2016/07/BMPP_PrivateCapitalPublicGood.pdf
15. Mobilizing Private Capital for Public Good(Rep.). (2010, December). Retrieved July 1, 2018, from Canadian Task Force on Social Finance website: https://www.marsdd.com/wp-content/uploads/2011/02/MaRSReport-socialfinance-taskforce.pdf
16. Looney, A. (2018, February 26). Will Opportunity Zones help distressed residents or be a tax cut for gentrification? Retrieved June 23, 2018, from https://www.brookings.edu/blog/up-front/2018/02/26/will-opportunity-zones-help-distressed-residents-or-be-a-tax-cut-for-gentrification/
17. Ehrenhart, A. (2015, February). What, Exactly, Is Gentrification? Retrieved July 26, 2018, from http://www.governing.com/topics/urban/gov-gentrification-definition-series.html
18. Levine, M., & Dubb, S. (2018, February 21). Opportunity Zones Provide New, If Flawed, Community Investment Vehicle. Retrieved July 5, 2018, from https://nonprofitquarterly.org/2018/02/21/opportunity-zones-provide-new-flawed-community-investment-vehicle/

Opportunity Funds.

- Aligning dollars with existing programs and investments.
- Making the public investment necessary to leverage private capital.

Minimizing harm and preventing displacement is critical

North Carolina is already experiencing development in many areas that is displacing current residents. Two major cities in North Carolina, Charlotte and Raleigh, have seen rapid rates of gentrification since 1990. Since 2000, 15.8 percent of Charlotte's census tracts have gentrified or are currently experiencing the process of gentrification. Raleigh has seen 13 percent of its census tracts gentrify since 2000. In 2016, only 16 percent of occupied housing in Durham County was affordable for a three-person household earning 60 percent of the median household income.[19] In Rocky Mount, a town about 45 minutes away from Raleigh, the city council has formed a working group that focuses on preserving and expanding affordable housing. [20]

Given where other states are headed with Opportunity Zones, it is critical that North Carolina put in place the following policies or systems to minimize the harm and to maximize the benefits of this program.

- Communities in designated tracts should begin packaging projects that meet community needs. to create a viable investment opportunities that are priorities for existing residents.
- Counties should formulate Opportunity Plans with the assistance of CDFIs that would: [21]
    - Allow communities to design and market prospective investment projects that match local needs.
    - Showcase the unique assets and advantages of designated tracts to attract investment that promotes equitable growth.
    - Incentivize investments that have high social return, e.g., child care centers.
- Policymakers can ensure that systems are in place to minimize displacement by: [22] [23]
    - Collaborating with workforce agencies to ensure that local residents have access to training that prepares them to be competitive labor demands in their area.
    - Prioritizing production and preservation of affordable housing and business space via land trusts, housing trust funds, and property tax relief.

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19. Kileen, J. (n.d.). Gentrification and Neighborhood Change. Durham.
20. City Council considers gentrification concerns. Rocky Mount Telegram. (2017, December 12). Retrieved July 3, 2018, from http://www.rockymounttelegram.com/News/2017/12/12/City-Council-considers-gentrification-concerns.html
21. Katz, B., Nowak, J., Rubin, J., & Berkovits, D. (n.d.). How States Can Maximize Opportunity Zones (Rep.). Retrieved July 5, 2018, from The Governance Projects website: https://governanceproject.org/assets/downloads/opportunityzonesstateactionplan_thenewlocalism.pdf
22. KKatz, B., et al.
23. Enterprise Community Partners. (2018, May 30). Opportunity Zones: State and Local Policies to Prevent Displacement and Attract Investment.