GUIDING PRINCIPLES *for* OPPORTUNITY ZONES

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EXECUTIVE SUMMARY

The Tax Cuts and Jobs Act of 2017 established an Opportunity Zones tax incentive, which provides a federal capital gains tax deferral and partial exemption for investments in designated Opportunity Zones. Governors in each state will select Opportunity Zones from an eligible group of low-income census tracts. Selections must be made by the third week of March 2018 (or third week of April 2018 if an extension is requested). *Given the significant interest among many private investors, it is possible that Opportunity Funds will attract tens of billions of dollars in private capital, making this one of the largest economic development programs in U.S. history.*

This policy brief puts forward four principles to guide the selection and development of Opportunity Zones. The principles are designed to enable the greatest job creation potential and the most significant advantages for lower income resident employment, both, inside and outside the eligible zones. Throughout the document we stress the use of data analytics, local knowledge, and the need to see these incentives as just one part of a broader economic development strategy.

1. **Principle One:** *Identify areas that demonstrate both social need and market traction.* Use a social needs index and job cluster data as the primary screen and then identify the deeper potential for equitable development by analyzing additional employment data along with transportation access data.

2. **Principle Two:** *Link capital investments to human capital strategies to maximize impact for lower income residents.* Focus on aligning skills upgrading with existing and future job growth both within and outside eligible investment areas.

** This policy brief was commissioned by The Governance Project, and prepared by New Localism Advisors, a firm co-founded by Bruce Katz and Jeremy Nowak. The Governance Project is a nonprofit organization supporting the work of a bipartisan group of high impact governors and mayors across a range social, economic and policy issues. Launching its first initiative in Spring 2018, TGP will offer state and local governments analytics, expertise and capital sources for policy initiatives. TGP will begin with a focus on economic opportunity strategies in distressed urban and rural communities and expand to initiatives in other policy areas including education, infrastructure, healthcare and more.*

3. **Principle Three:** *View Opportunity Fund investment capital as integral to a comprehensive, multi-year investment strategy that leverages and partners with additional public, private, and independent sector debt and equity providers to build sustainable businesses, ensure a skilled workforce and strengthen community development* both within eligible zones as well as in contiguous areas.

4. **Principle Four:** *Ensure a high quality data system to collect information on investments and provide a feedback loop for ongoing measurement and improvement.* We are less interested in expensive evaluation models than the ongoing disciplined use of data to inform ongoing operations and maintain long-term accountability.

TAX CUTS AND JOBS ACT OF 2017

The Tax Cuts and Jobs Act of 2017 established an Opportunity Zone tax incentive, which allows taxpayers to defer paying federal tax on capital gains from the sale of property if those gains are invested in Qualified Opportunity Funds that invest 90% of their assets in businesses located or property used in a designated low-income community. Investors receive modest reductions in their eventual tax bill if they maintain their Opportunity Fund investments for at least five and then seven years. Investors that hold capital in those funds for a full ten years also do not have to pay capital gains tax on the appreciation of their Opportunity Zone investments.

The census tract eligibility criteria for the Opportunity Zone incentive mirror the low-income tract criteria for the New Markets Tax Credit program. Unlike the New Markets Tax Credit program where there was universal eligibility for all low-income census tracts, the Opportunity Zones program directs the chief executive in every state and territory (including Washington D.C.) to choose up to 25% of their tracts to be eligible. In addition, five per cent of Opportunity Zone tracts may also be non low-income as long as they are contiguous to a qualified, nominated tract and their median income does not exceed 125% of the contiguous qualified tract.

Making selections will generate demand for equitable distribution across urban, suburban, and rural communities. Those states that do the best job will also want to apply criteria and supporting data as the basis for selections. A strong selection *theory* holds potential for maximizing the number of investable projects and businesses, on the one hand, and access for low-income residents to those jobs, on the other.

21ST CENTURY PLACE-BASED STRATEGIES

Public policy analysts commonly distinguish between *place-based* and *people-based* approaches to poverty reduction. Place-based approaches invest or incent investments in specific communities based on assumptions regarding a deficit of capital, jobs, housing or infrastructure in those areas.

People-based investments flow directly to households (e.g. earned income tax credit) irrespective of where someone lives or works.

The history of place-based public policy in America is complex and includes early 20th century rural electrification, War on Poverty programs like the Appalachian Commission and Model Cities and a variety of business incentive and capital investment strategies including enterprise zones, empowerment zones and New Markets Tax Credits. In addition to federal efforts many place-based programs are sponsored by state and local governments. Philanthropy has also utilized place-based strategies in support of community development and poverty alleviation. Every city and county in America can point to geographic zones with specific incentives tied to its redevelopment from main streets to industrial corridors.

The history of place-based programs is uneven with respect to both community revitalization and poverty reduction outcomes. One limitation of many place-based programs is the failure to take into account the dynamism of demography, markets, and counter-incentives (school quality, regional economic trends) in society at large. Opportunity Zones will succeed if states take a dynamic, market-oriented perspective in selecting them that takes into account how integrated the zones are with surrounding communities and pays attention to issues of labor supply as well as capital demand.

Place-based programs in a 21st century economy must recognize four characteristics of economic reality.

1. **Employment Clustering:** Job growth is increasingly clustered in relatively small geographies around downtowns, medical and research institutions, and communities where there are strong entrepreneurial ecosystems. The advanced economy increasingly favors places where talent, research, quality amenities, and startup innovations co-locate. It is also important to look at emerging job clusters in more rural areas. The number of jobs differ but the co-location dynamics are the same.

2. **Training and Access:** The major driver of labor market attachment is work force quality and job accessibility. While job requirements change rapidly due in large part to technology, there is a premium placed on adaptive technical and inter-personal skills. Communities with strong training programs linked to industry and quality transportation hold an advantage.

3. **New Forms of Capital Intermediation:** There is an abundance of global capital, but it is place agnostic and not always suitable for every stage of business growth or project development. Moreover, global capital flows focus on sectors and products more than places. Opportunity Funds create the potential for expanding the quality of intermediaries that have two essential qualities: local knowledge **and** capital markets credibility.

4. **Technological Disruption:** Advances in technology are radically altering how residents and institutions understand, navigate, experience and communicate within and across places. Opportunity Funds should take advantage of or experiment with technologies to boost resident engagement, strengthen employment linkages, accelerate product and process innovation and enhance quality place making. This may be particularly important for rural communities that lack large employment clusters but have strong work force capacity.

Place-based programs must internalize these facts. In order for place-based programs to reach their fullest potential, however, *places* themselves need complementary strategies to address these economic realities and position their residents to access new employment opportunities in a changing economy. Tax incentives are not a magic solution to the basics related to job growth and labor quality. The Opportunity tax incentive is a tool and not a program. It must be reinforced by other economic development strategies to maximize its value, particularly for inclusive growth.

AN INITIAL SCREEN: MARKET TRACTION AND SOCIAL NEED

Our primary screen for the identification of preferred tracts is the co-existence of market traction and social need. By market traction we refer to places where there is significant but unrealized potential for job growth as evidenced by existing job clusters or relative proximity to job clusters, as well as transportation access for low-income residents to those jobs. By social need we refer to communities where income, labor market participation, poverty rates, and educational attainment demonstrate a limited capacity to attract investment absent a policy carrot and yet signify the potential to benefit inordinately from a resuscitation of market activity.

There are many ways to identify the intersection of market traction and social need. We began by mapping social need based on the interplay of variables listed below.

- % Population below poverty
- % Households with rent or mortgages greater than 30% of income
- % Population not in the labor force
- % of Population with less than a high school degree
- Gini index of concentrated income

We applied a factor analytic methodology to the variables in order to construct a weighted composite index of social need. We then mapped all eligible census tracts using the index. The map below shows the city of Philadelphia's eligible census tracts mapped with respect to levels of need. The rank is relative to all other eligible tracts in Pennsylvania. We differentiated among ten levels of need. The map shows 296 eligible tracts with varying levels of social need. The question then is how to best make choices among these eligible tracts.

To help make choices along our social need-market traction axis, we applied national employment data from the Longitudinal Employer-Household Dynamics database. The data is collected at the block level and can be aggregated up to census tracts. Moreover, it is updated annually and can be easily mapped.

The map below shows Philadelphia with the census tract differentiation based on social need scores and the jobs cluster data for areas that have at least 1,000 jobs clustered at the block level. The larger the circle, the greater the number of jobs.

The overlay of jobs and need is one initial screen to identify strong investment choices. In making selections there may be trade-offs between social need and market traction among eligible tracts. In census tracts where there are job rich clusters and a high level of social need, the selection process is relatively easy.

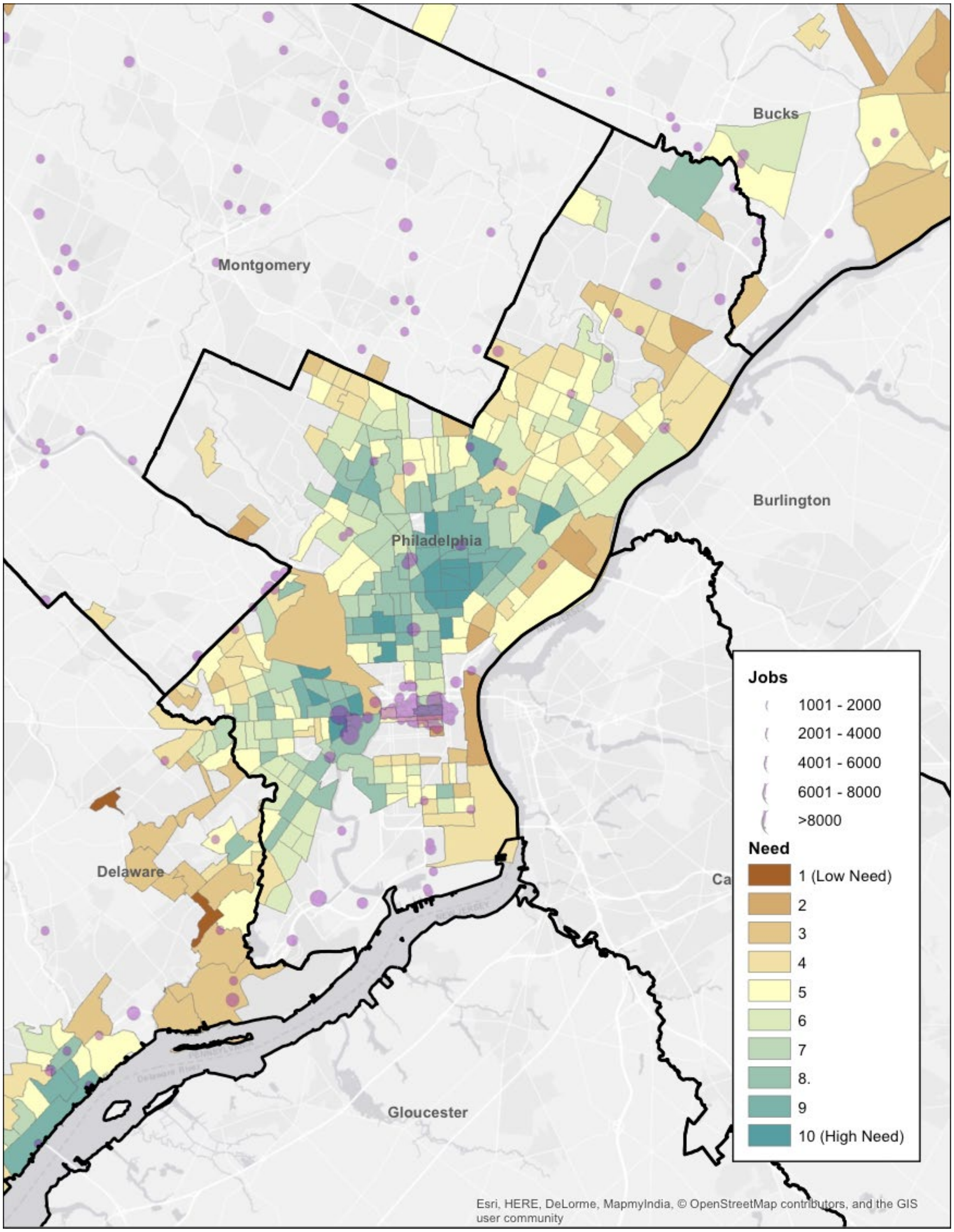
If there are no clear instances of high levels of job growth and high levels of social need, we favor trade-offs that emphasize job clusters within eligible tracts, even in instances where the social need is not the highest among all low-income eligible tracts. This strategic choice is driven by a primary emphasis on job growth and our understanding that job access and employment skills will do more to increase household income than the absolute proximity of jobs and social need.

While many rural communities do not have the same employment clusters as urbanized counties, the selection principle remains the same. Identify main streets and business parks where there are existing jobs and growth potential including communities contiguous to those places. Local knowledge is critical to identifying emerging business growth opportunities in rural areas.

It is important to note that this is a market-based program that does not guarantee investment in any selected census tract. Tracts with some pre-existing employment base, including newly emerging hubs, will often provide a stronger signal for new investment to follow suit. High social need tracts adjacent to job hubs may be candidates for increased investment from the job anchors to adjoining communities.

In many cities, the lag in data availability means that some census tracts may have experienced substantial market renewal even though they still qualify for Zone selection, raising the specter that the Opportunity Funds will be used to further gentrification and displacement of existing residents. To the greatest extent possible, governors and local officials should take account of current market conditions when designating Zones and avoid subsidizing investment that was already going to occur regardless of this new incentive.

It should be noted, however, that gentrification varies substantially across cities in terms of intensity, applicability and geography. The experiences of Boston and San Francisco should not be confused with the realities of Detroit and St. Louis. We believe that recent market renewal in the central business districts, midtowns, and university or medical districts of former industrial cities is a strong reason for selecting those areas if they are eligible. After decades of hollowing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out, these engines of American prosperity still need help building modern industries to power the next generation of growth and prosperity.

Governors and local officials should balance concerns around gentrification with the need to establish strong employment and fiscal bases in the cores of cities and urban counties, as well as rural communities.

A SECONDARY SCREEN: JOB CHARACTERISTICS AND TRANSPORTATION ACCESS

The capacity to invest in a census tract with a job rich ecosystem does not mean that the people in that tract will be able to access those jobs. Moreover, to fulfill their employment needs, firms hire from throughout a city, county, and region. In order to maximize the value of Opportunity Fund investments for low-income persons both within and outside the selected tracts there are two things that are necessary to demonstrate in addition to the primary data on social need and market traction:

1. that there is easy transportation access to those job centers from adjacent communities with high levels of social need
2. that there are a reasonable number of jobs in the selected communities with entry level employment capacity

While it is easy to measure distances between job clusters and low-income communities, that is not the same thing as transportation analysis. We can use transit shape files that can be downloaded for mapping but their quality is uneven. Local transportation data and conversations with employers and public officials can be helpful in measuring or approximating transportation costs and distance.

In terms of job suitability, the same database that we used for market traction analysis can be explored further to identify other employment characteristics: industry sector, employment codes, size of firm, income of jobs, and other variables. This allows us to get a relative sense of the availability of jobs for various skill levels that churn through incumbent firms and may emerge through new capital investments. In this context it is important to be aware of places where there is a high dependence on a single employer or a few employers that may be closing or have recently cut back operations. This could have negative or positive consequences for future investments.

Existing job data is far from a perfect approximation of future jobs given the changing nature of employment and technology. But coupled with direct local knowledge from civic and business leaders, it can add value to the selection process. For very low-skilled job access we might use data that shows jobs available to those with a high school degree or jobs available at a particular monthly income level.

This secondary screening – transportation and job categories - is a way to understand the potential for increasing the relevance of the eligible tracts for lower income residents. The answers will not be perfect but the inquiry can inform selections, particularly between tracts that have relatively similar social need and market traction profiles. With respect to transportation and transit, it goes without saying that national and global transportation hubs such as train stations and airports are critical assets around which employment clusters may grow. Where eligible, they may have a strong connection to low-income employees via public transit.

FINANCIAL AND HUMAN CAPITAL: THE INSTITUTIONAL NEXUS

The Opportunity Zones have the potential to unleash significant capital into distressed communities. But the effectiveness of the incentive will depend on three factors over and above smart zone selection: 1) local capital investment capacity; 2) the quality of skills upgrading or human capital programs; and 3) the sophistication of local institutions that play various matching and development functions.

Capital for various stages of business growth and development, along with a wide range of quality training programs are two critical factors to a quality enterprise ecosystem. Planning for the Opportunity Zones program ought to take an ecosystem perspective around these two issues.

The Opportunity Zone capital will naturally be constrained by regulatory prescriptions both with respect to term and timing. Until the final regulations are issued and subsequent IRS rulings made, we cannot determine the best and primary use of the capital. But we know that it can flow into new businesses, expanding businesses, commercial and residential development projects, brownfield refurbishment, some infrastructure assets, and more. We also know from experience that communities that thrive have competitive and collaborative capital sources.

The most important thing for local communities to do at this point is to have clarity around the effectiveness of various capital intermediaries from banks to venture capitalists to community investors and determine the potential role for Opportunity Funds in the mix. Moreover, it is important to identify ways for multiple intermediaries to work together on projects—be they nurturing startups, revitalizing Main Streets, or bringing innovation districts in all their complexity to life.

At the same time, a similar inventory of human capital strategies ought to be compiled with a focus on effectiveness from the perspective of employers. If the new capital is going to assist low-income residents then it must be deployed into job creation opportunities that are aligned with skills upgrading programs. Cities and states will be responsible for aligning those with their business and civic partners.

One final lesson from place-base revitalization efforts: institutions matter. Over the past twenty years, a variety of institutions – business improvement districts, local development corporations, business incubators and accelerators – have been created to drive quality place making, enhance entrepreneurship and innovation, maximize resident-to-jobs linkages (particularly with anchor institutions) and spur development that is mixed-use and has market rate and affordable elements. Communities and intermediaries should strive to capture and codify best-in-class institutional models that can be adapted and adopted across places.

The ultimate effectiveness of Opportunity Zones will rely on the capacity of communities to align a variety of capital sources and training initiatives and pursue institutional innovations within the context of capital deployment. Otherwise the value of the incentive in terms of deal generation and low-income labor market success will be diminished.