Opportunity Zones: Here We Go Again

By Richard Cowden

"I feel like I've been here before..." *Déjà Vu*, Crosby, Stills, and Nash

Introduction

The newly hatched opportunity zone program represents the first time since 1993 a true federal enterprise zone-styled policy has reached the operational stages. Like the early proposals advanced by Rep. Jack Kemp, it will test whether capital gains tax incentives can have a positive impact in urban and rural areas.

However, the Trump administration also countenances the use of targeted federal resources to augment the program. It all sets up the potential for retooling an economic development concept that cities and states have dabbled at over almost 40 years but never fully implemented.

Free Trade Zones. Foreign Trade Zones. Enterprise Zones. Empowerment Zones. Hub Zones. Opportunity Zones. According to experts, the common economic theme originated with the 12th century Hanseatic League cities of Northern Europe and the Baltic region, which waived various trade-based fees for commercial interests and spawned a long-enduring network of cooperation.

The most recent variation on the concept is Opportunity Zones, which began as a low-profile provision attached to the 2017 Tax Cuts and Jobs Act. Under the 2017 program, capital proceeds from the sale of stock that are reinvested in an OZ-based company--or an "O-Fund" that invests in OZ companies--can be partially shielded from federal capital gains taxation. The taxpayer gets a 10 percent step-up in basis for the reinvested gains if held in the zone for five years and a 15 percent step-up if held for seven years. If the investment remains in the zone for at least 10 years, the capital gain on earnings during that time may be exempt from taxation altogether.

A Brief History

A capsule summary of the years between Rep. Jack Kemp's first enterprise zone bill in 1980 and OZs would note Kemp never saw his vision of EZs signed into law. It floundered legislatively throughout Ronald Reagan's two terms and during George H.W. Bush's term, when Kemp served as secretary of the Department of Housing and Urban Development (HUD).

Bill Clinton listed EZs as one of his third-way campaign promises in 1992. He created the Empowerment Zones/Enterprise Communities program during his first term and moved on to other matters in his second term.

George W. Bush basically punted on domestic policy, except for a lenient regulatory policy on real estate lending of all types, throughout his two terms.

Barack Obama used up all of his political capital on an emergency stimulus package, health care policy, and banking reform in his first two years, then lost both House and Senate majorities. He designated 22 areas in urban, rural, and tribal communities under his Promise Zones initiative. It offered priority support to the zones from several federal agencies, but Congress never backed the policy up with legislation.

In sum, over the past 40 years, we have had one high-profile federal proposal that never passed, but left hundreds of state-designated zones in its wake. (More on that later.) Then we had one Democratically designed EZ-ish program that neither the administration nor the Republicans really liked. Then, by 2000 the trail went cold--except for those pesky state-designated zones. And now we have OZs, despite nearly universal disagreement in Washington among partisans on virtually every other issue.

In retrospect, it still seems odd that neither party had the wit soon after Kemp dropped his first bill to see the opportunity for a kind of syncopated bipartisanship around enterprise zones. Republicans didn't worry about revenue foregone in the process of offering tax incentives, and didn't mind targeting them to inner cities. (I once asked a GOP economic operative what he thought about a new EZ tax incentive idea and his response, only half tongue-in-cheek, was, "As long as it loses revenue, it's fine with us.") And when Kemp came calling, Democrats, who often advanced various tax incentives of their own, might have welcomed the prospective inner-city jobs that any stimulus package might produce.

Many believed this political formula would win the day when Kemp introduced EZs. But it didn't work that way. The partisans, locked in the same bitter dispute over supply-side economics that overhangs domestic policy discourse even today, bore so much enmity for each other that what appeared on the surface as a slam dunk became instead an air ball.

Kemp's bid for inter-racial harmony and expansion of opportunities across classes came with some rigid conditions Democrats found unpalatable. He refused to link the tax incentives in his proposal with any other federal spending. Kemp pointedly walked away from any suggestion of a compromise that would add a penny of new federal funding for the EZs. He even rejected out of hand the suggestion that zones should receive revenue-neutral priority in accessing existing federal resources for land development, pollution abatement, public transit, etc. No, EZs must serve as an unadulterated demonstration of supply-side magic and the blessings of regulatory relief.

Kemp's principal opponents in the House, Rep. Daniel Rostenkowski (D-IL), who chaired the House Ways and Means Committee, and Rep. Charles Rangel (D-NY), a key member of that committee, barely tolerated hearings on Kemp's proposal but blithely danced around bringing it to a vote. The Democratic riposte to Kemp was that the cities needed the federal urban funding Reagan had cut, not a nebulous set of tax abatements. For his part, Kemp was glad to continue talking up the legislation--and burnishing his reputation--and to portray the Democrats as obdurate.[1]

City/State Involvement

My own small role in this chapter of U.S. urban policymaking was as founder in 1985 and executive director of the American Association of Enterprise Zones (AAEZ), which grew out of research to determine if the early state EZs were attracting business investment and creating jobs. By 1990 most states had set up an EZ program and hundreds of state-designated EZs operated around the country. Working with state and local economic development personnel, we formed AAEZ as a 501(c)(4) organization in hopes of giving a voice to those most directly involved in the states' programs as Washington muddled through the legislative process.

Much to our dismay, Democrats on Capitol Hill tended to regard us as conservatives, even though we represented mostly Democratically dominated cities seeking to help poorer, mostly minority neighborhoods. Our members knew the Great Society programs were going away and accepted that enterprise zones were about all they could expect from the ascendant Republicans. We advocated a series of compromise provisions, such as federal targeting of existing federal programs to the states' EZs, and we made a point of remaining politically neutral. We just wanted to nudge the debate between the supply-side zealots and the dug-in never-Kempers off dead center.

Different Implementation Models

Another distinction between Kemp's proposal and OZs is that EZs were expected to be implemented gradually, with 25 zones designated annually through a competitive process. The OZs kicked off in 2018 with 8,700 designations that arbitrarily met the distress criteria set out in the legislation.

We learned during the EZ era that requiring the nominated areas to participate in a strategic planning process combining enforceable pledges of state and local assistance helped give the programs greater impact, especially considering the meagerness of the state tax benefits. And that has been reflected in subsequent studies looking beyond the effects of tax incentives alone. ("Rhetoric versus Reality: A Review of Studies on State Enterprise Zone Programs," Journal of the American Planning Association, 1996). AAEZ preached that merely dangling a tax break or

[1] The stalemate in urban policymaking during the entirety of Reagan's and George H.W. Bush's presidencies, for which Kemp and Democratic partisans largely were responsible, is chronicled in a *Journal of Applied Research in Economic Development* article, "Lessons From the Past for Urban Policy in the Era of Trump."

two, regardless of how generous, cannot obviate the need for commitments to the nuts and bolts of redevelopment.

Enterprise Zone Critiques

Just Googling "Enterprise Zone Research" will bring up plenty of skeptical reports with headlines such as "Enterprise Zones: The Zombie Idea That Just Won't Die." (Urban Affairs Forum, 2017). A close read of these analyses, however, suggests the authors weren't really evaluating the zones as a planning framework but were litigating the merits of tax incentives. Much of this research has zeroed in on zones the states designated in the '80s and early '90s, at a time when they anticipated an eventual congressional compromise and enactment of a federal EZ policy.

The early adopters were simply trying to put a planning strategy in place so they could be first in line for federal EZ status, just in case the DC political logjam broke and Congress passed Kemp's bill. That federal component never came to fruition.

Clinton, in the wake of the 1992 South Central Los Angeles riots, proposed his own variation on the theme. At first it seemed a hopeful sign that a policy not freighted with Kemp's fantasy of saving the inner cities with tax incentives came from the Democratic side of the aisle. But Empowerment Zones/Enterprise Communities tore up the script written by the hundreds of existing state-designated zones and started with a fresh draft and brand new eligibility standards and designation processes.

Clinton's team effectively cashiered all of what the states had learned up to that time, which in many cases included a decade of experience and data. AAEZ had recommended that the administration build on what the states had already done. We thought zones meeting a federal eligibility standard should be in line to compete for even more substantial support.

The administration did incorporate our two-tiered idea into their 1993 legislation, as reflected in the EZ/EC format. And they heeded our advice that the program should involve more than tax breaks. But instead of learning more about what was working and not working in the states' EZs, the Clinton administration launched immediately into a program that called for a nationwide competition to win one of only six urban empowerment zone designations. One hundred enterprise community designations went to both rural and urban applicants.

On the plus side, the program induced applicants to engage in a joint local and state planning process and to line up feasible, targeted commitments to the selected areas. Local business interests also were invited to support the plans and in many cases they became serious stakeholders.

On paper, and to some extent in reality, this was a singular and heartening feature of the EZ/EC experience. In practice, however, the competition for designations all too often devolved into an old-fashioned food fight, complete with lobbyists and backroom deal-making. (Rostenkowski and Rangel were rumored to have wired designations for their districts). At stake were the $100 million block grants that the program allocated to the lucky few urban empowerment zone winners. Each EC received a $3 million block grant and some relatively minor tax benefits. The EZ tax incentives? Truth be told, the applicants themselves hardly gave a thought to the program's hiring tax credit, which topped out at $3,000 annually to companies for each zone resident they employed. Who cares about having that incentive available to some future business prospect when $100 million is on the table?

So in a sense, yes, the state-designated zones had become zombies because they had been selected into existence but the expected federal role never materialized from either Republicans or Democrats as they moved in and out of power in Washington. The empowerment zones and enterprise communities have long since expired; what's left for the skeptics to feast on are the many state EZs, which never received federal recognition, coordination, priority, funding, or incentives.

What essentially none of the state enterprise zone critiques include in their data or their observations is that the programs frequently are not just a tax incentive scheme; they are ongoing revitalization activities, which are concentrated a bit more by the zone boundaries than they would be otherwise. Often they are the same redevelopment assignments that had been tasked to local planners and administrators before anyone hatched the notion of tax incentives. Some performed fairly well and others did not, but nobody at staff level thought the tax packages would make a critical difference.

What the state EZ designations offered was permission to use the words "Enterprise Zone" in their promotional campaigns and the right to make the best of a fairly perfunctory set of state tax abatements. When you pull back the curtain, the state EZs are just people trying to clean up some derelict sites, attract some business, and create some jobs within the lines assigned to them by their designation.

Tips and Advice

All of which leads to the first of some friendly tips to those who will implement the 8,700 opportunity zones. You will have access to one federal tax incentive but unless your state lawmakers adopt complementary enabling legislation, you may have to improvise state and local incentives and physical improvements. The press and academia may be kinder to the OZs than to EZs, but be prepared for some critical reports. One critique published by Citylab in May 2018 ("The Problem With Opportunity Zones"), just five months after OZs were signed into law, has already cast shade on the program, declaring, "Unfortunately, if history is a guide, it won't work."

A lot of the harshly negative studies on zone programs have been and will be aimed at disproving Republican tax theories but they may hit innocent victims. So far virtually all have ignored what often are well-considered non-tax incentive features of zone programs. The impact of a street lighting project or an abandoned industrial site cleanup never shows up in an EZ cost-benefit report. Yet those are the kinds of logical long-range measures economic development directors can and should take in the context of their zone program.

Concentrate on Basic Economic Development Goals

Therefore, Tip One: Use the O-Fund to attract investors, but do not let the program be characterized as a tax incentive gimmick. Be prepared to demonstrate to analysts and the media that the zone implementation strategy contains several practical objectives and involves resources other than tax abatements. Highlight public works upgrades that in time will help reverse the perception and reality of the zone's business environment and quality of life.

What may be fortunate for OZs is that the Trump administration itself appears to have set aside (or perhaps has simply forgotten) Kemp's doctrine that the zones should rely entirely on tax and regulatory relief. On Dec. 12 the administration kicked off its OZ policy with an executive order directing federal agencies to offer the zones priority access to development assistance. That might come in a number of forms from agencies such as the departments of Housing, Labor, Commerce, Agriculture, to name a few.

On the down side, that welcome change of attitude comes at a time when many of the federal programs that could play a role in priming redevelopment in the OZs have been stripped to the bone or phased out. For example, since the '70s, cities have commonly used Community Development Block Grants (CDBG) to fund, among other priorities, infrastructure projects, economic development, and land acquisition. At its height in the late '70s, CDBG funding amounted to about $13 billion annually (in 2016 dollars); by 2014, CDBG had shrunk to about $3 billion.

It's the Boundaries, Stupid!

Tip Two: The boundaries themselves are the most important aspect of any zone-based program. Just the act of setting boundaries can give the program a useful sense of focus. It sends a message to residents and potential investors alike that local authorities expect this area to improve, to be the flourishing place to live and to locate.

Another advantage to boundary-setting is that all areas of a city demand upgraded services and facilities; the zone boundaries give local officials a predicate for postponing improvements to more affluent neighborhoods in favor of targeting resources to the poorest, especially if doing so gives the city better prospects to access more federal aid. Yes, when economic development professionals and elected officials cite the need to prioritize the zone, they may get a bit of political cover.

It all begs the question of why we propose area-based economic redevelopment policies. The simple answer, of course, is that poverty and business facility abandonment cluster in obvious, measurable patterns. And the cause-and-effect relationship between the two also is clear. Populations that lack mobility suffer when the industries they rely on shut down or move away.

Think Outside the Zone

<u>Tip Three</u>: Now that OZs are facts on the ground, several hundred senators and representatives have a vested interest in their progress. Congress is unlikely in the near term to pass new legislation to provide more funding just for the OZs. However, both Republicans and Democrats have voiced a keen interest in a major new infrastructure initiative.

Should such a proposal see the light of day, it might offer preference to the OZs, or perhaps a component of it could be crafted to set aside support specifically for the zones. It might call for the existing OZs to compete for a higher level of designation that provides more resources for physical and service improvements. Indeed, the states and congressional districts that host the current OZs could form an advocacy base for infrastructure legislation.

If somehow a new mood of bipartisanship should surface in Washington, perhaps OZ advocates could push for legislation that would provide additional motivation for cities to enhance and innovate around the concept. For example, the initially designated areas might be the first tier of a program that invites localities to compete for deeper incentives, such as infrastructure support. Those exhibiting creativity and mutually reinforcing commitments from municipal and state sponsors, as well as partnerships with private stakeholders, could be eligible for the most generous federal assistance.

Human Services

<u>Tip Four</u>: OZs should be a redevelopment program, not a social services program. Almost from the beginning, opponents of enterprise zones have argued that what people in low-income communities need is better access to the entire range of support for human needs. So stipulated, but they also need jobs.

This is possibly the most important--and bedeviling--conundrum in the urban planning field. Should urban policymakers attend to the unmet needs of people and let the physical environment sort itself out? Or should they make the city better able to take care of its citizens through economic opportunities? I don’t think these matters are mutually exclusive, but they are different policy issues.

Geographically targeted programs should focus on business development and on infrastructure, including incentives to rehabilitate properties, not on human services. If families need better human services, it doesn’t matter whether they live within a defined area. A program that would give better health services, for example, to those living on one side of a line than those on the other simply would not be fair. The formula that concentrates a human services program to underserved groups should reflect the demographics of the community, not the geography.

On the other hand, localities where business has cratered, leaving abandoned facilities behind, can be identified in recognizable patterns. The measures needed to make those properties useful again do lend themselves to an area approach. In short, zone-based policies should be a commitment to the physical plant of the city; they should not try to be all things to all people.

London Docklands

By far the best example of an enterprise zone that fulfilled its promise was among the first to be designated in London's Docklands.[2] After recognizing that the purposes for which the Docklands took shape in the Industrial Age evaporated as shipping shifted from the Thames to coastal docks, the Brits completely reconfigured the area's infrastructure, and, by the way, they also offered tax incentives. The public investment, which was substantial, paid off and the Docklands now represent one of the driving forces of London's economy.

On a smaller scale, we've seen a number of innovative, though modest, measures carried out in the states' EZs and EZ/EC programs. Just a few examples included:

- Small business incubators--Schools and vacant warehouses or factories have been converted into low-cost centers for business start-ups.
- Vest-pocket parks--Beautification of abandoned properties turned into public spaces through partnerships with local business groups.
- Storefront rehabilitation--Design projects involving local retailers, with assistance from local public agencies.
- On-site job training--Facilities developed in conjunction with a company moving into a vacant building and supported by vocational education organizations.
- Site assembly--Demolition of abandoned properties and preparation of properties for future adaptive re-use.
- Transit-oriented development--Strategic location of multi-modal public transportation facilities designed to stimulate mixed-use development.
- Tax increment financing--Issuance of bonds to repair streets, sidewalks, sewer systems, in anticipation of future tax revenue generated by prospective new business.

Federal urban policy, even at a time of fiscal strain, should actively encourage states and cities to take on these and other kinds of activities that preserve land and promote infill development. If that can be accomplished through a program that has the word "zone" in it, America would be better for it.

[2] Great Britain's experience with the conversion of the Docklands from obsolete commercial wharves to vibrant financial, commercial, and residential enclave is described in more detail in "Lessons From the Past for Urban Policy in the Era of Trump."

Suburban and Rural Zones

Tip Five: Adapt OZs to older suburbs and rural areas. Enterprise zones, as conceived by the British, were distinctly an urban program. The criteria spelled out in the early U.S. enterprise zone proposals envisioned rural designations and so did the Clinton era EZ/EC program.

The OZ designation criteria apply to any location that falls within the prescribed distress standards. It stands to reason that economic challenges occur, not just in inner cities, but in suburbs that also have experienced losses of industries and that have seen their infrastructure age and decay.

Conditions in rural or exurban areas similarly may reflect joblessness and rising poverty when a key industry moves away. Rural regions stricken by plant closures formed the backdrop for President Trump's campaign appeal about the loss of entire business sectors to China. Whatever the reasons for the hemorrhage of industries, a plant shutdown in a sparsely populated area can have a devastating regional effect. Jobless workers in such areas have fewer employment alternatives than workers in an urban area that loses a big company.

On the other hand, many older inner cities have suffered multiple industry losses, resulting in widespread incidence of derelict properties. The cost of rehabilitating and decontaminating these sites is so prohibitively high that they typically remain unoccupied and deter re-use. Unlike rural areas, where other properties are readily available if a plant closes, older high-density areas may find it much harder to attract new investment as available and suitably structured sites are in short supply.

The challenge in urban, suburban, and rural areas may be equally difficult but the nature of the challenge will be different in each case.

Policy Evaluation

Tip Six: Push for bias-free research into policy outcomes. The vast majority EZ analyses have looked only at the cost-effectiveness of tax incentives and many have been structured to limit the scope in ways that filter out indirect or downstream effects.

For example, some studies have measured only jobs created by the companies that use the incentives. But moving a primary employer, such as a manufacturer, into a zone often attracts secondary investments, such as a cafe or mom-and-pop store, that may not be eligible for the offered incentives. Sometimes the secondary investment may locate just outside the zone but creates jobs in response to the EZ incentive.

As noted earlier, measures taken by the local zone sponsor in support of the program may not be captured in the data at all, even though they can generate significant future benefits.

The Trump administration should take steps soon to test how various approaches to the OZ perform. Some localities may do little more than call attention to the zone's eligibility for O-Fund investment, while others may integrate the OZ into a broader redevelopment strategy.

Dividing a universe of OZs into these two categories and studying their outcomes over time would help guide future policies. With a population of 8,700 OZs, they would have more than adequate sample sizes to produce statistically significant results. Doing so could go a long way toward determining whether, as the supply-siders believe, tax incentives are a cost-effective way to revitalize distressed areas or whether more comprehensive strategies give a better bang for the buck.

Conclusion

Until recently, Washington, D.C., has offered practically nothing new that cities and states can use to restore economic vitality to neighborhoods in decline. But it will be hard to ignore the 8,700 OZs across the nation. They surely will set off a fresh debate about how to address problems of localized poverty. But they also will offer a new and possibly salutary challenge to economic development practitioners.

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