JOHN W. LETTIERI
PRESIDENT & CEO
ECONOMIC INNOVATION GROUP

TESTIMONY BEFORE THE U.S. SENATE COMMITTEE ON SMALL BUSINESS AND ENTREPRENEURSHIP

"Expanding Opportunities for Small Businesses Through the Tax Code"

October 3, 2018

Introduction

Chairman Risch, Ranking Member Cardin, and members of the Committee:

My name is John Lettieri and I am the President and Chief Executive Officer of the Economic Innovation Group (EIG), a bipartisan research and advocacy organization based in Washington, DC. Thank you for inviting me to testify regarding implementation of the new Opportunity Zones tax benefit, which became law as part of the *Tax Cuts and Jobs Act of 2017* (TCJA), and holds the potential to promote much-needed economic growth in struggling communities nationwide.

EIG was deeply involved in the development of the *Investing in Opportunity Act (IIOA)*, which garnered broad bipartisan support and served as the basis of the Opportunity Zones provision in the TCJA. We were honored to work closely with several members of this committee, including Senators Tim Scott (R-SC) and Cory Booker (D-NJ), the lead sponsors of IIOA. Since Opportunity Zones became law, we have worked with an array of important stakeholders nationwide, including state and local policymakers, community organizations, major philanthropies, and leading investors to raise awareness, provide analysis, and gather feedback. Those efforts helped to inform detailed technical recommendations that we, alongside a coalition of stakeholders, provided to the Department of Treasury and Internal Revenue Service (IRS) in support of timely and effective implementation.[1]

Opportunity Zones are the most innovative and ambitious federal attempt to encourage long-term private investment in low-income communities in at least a generation. While the incentive was designed to support a wide variety of needs across communities, its central purpose was to drive investment into operating businesses in underserved areas – particularly *new* ventures and existing small- to medium-sized businesses poised for growth. This fundamental goal must now be reflected in the rulemaking process. Simply put, if in practice the forthcoming regulatory framework inadvertently biases the tax benefit towards real estate investment or hampers the formation of multi-asset funds to invest in operating businesses, it will fail to achieve its true

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[1] Economic Innovation Group Opportunity Zones Coalition. "Economic Innovation Group Opportunity Zones Coalition Letter." Received by U.S. Department of the Treasury and David J. Kautter, 18 June 2018. Letter. https://eig.org/wp-content/uploads/2018/06/Opportunity-Zones-Coalition-Letter_6.18.18.pdf

dynamic potential. Instead, Opportunity Zones would be at risk of repeating the shortcomings and narrow scope of past policy efforts.

Why are Opportunity Zones needed?

Before going further, it is worth briefly addressing the issue that prompted the development of Opportunity Zones: the deeply uneven economic recovery from the Great Recession. While there is much to celebrate regarding the strength and resilience of the U.S. economy at the national level today, far too many communities are being left on the sidelines in the midst of a prolonged economic expansion. The *geographic* distribution of jobs, businesses, and wage gains during the recovery has been highly concentrated. One finding from forthcoming EIG research helps to illustrate this point: As of the end of 2016, less than *one quarter* of U.S. counties had gained back the number of businesses they lost to the recession. I believe regional inequality within the United States will be recognized as one of the defining economic challenges of our era, and Opportunity Zones is the first major federal effort to address it.

The map of Opportunity Zones

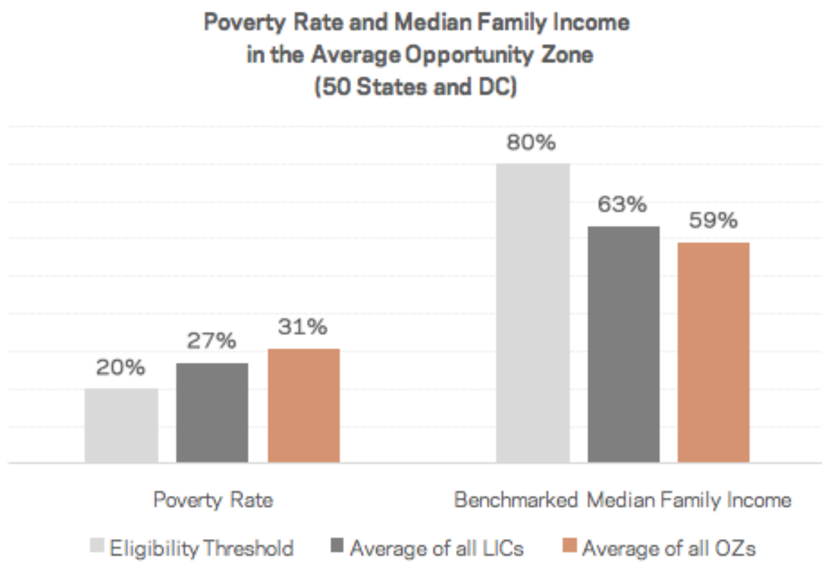
One of the most important features of the Opportunity Zones policy is the role given to governors in determining where the incentive will apply. Congress established a national framework to identify the census tracts eligible to become Opportunity Zones, but tasked governors with down-selecting and submitting their nominations based on local input and priorities. On the whole, governors did an effective job in managing a thoughtful, analytical, and rigorous selection process nationwide. They tailored their selections to the need and potential of their communities, and relied heavily on public and local government engagement, analytics, peer-learning, and interagency collaboration.

Governors selected significantly higher-need places on average than the law required, but worked hard to strike the right balance between local need and market opportunity. The following are statistics from EIG's analysis of the nearly 8,700 certified Opportunity Zones in the United States and territories.

- Roughly 10 percent (31.3 million) of the U.S. population resides in Opportunity Zones.[2]
- The poverty rate in the average tract is 31 percent.
- The median household income in the average tract is only 59 percent of its state or regional median.
- Nearly 70 percent of the population in Opportunity Zones resides in a census tract that is "severely distressed" according to the U.S. Treasury Department's CDFI Fund.
- The average life expectancy in Opportunity Zones is a full three years shorter than the national average.
- The median home is more than a decade older in Opportunity Zones than it is nationally.
- Thirty-eight percent of resident adults in designated areas are not working, which is 10 points above the national rate.

[2] The number grows to 35 million when including the U.S. territories and Puerto Rico.

- Three-quarters of zones are located in zip codes that experienced at least some level of post-recession employment growth from 2011-2015.
- Minorities make up 56 percent of the Opportunity Zones population.
- Fewer than four percent of the designated tracts have experienced rapid socioeconomic change (a proxy for gentrification) since 2000.[3]



These findings demonstrate the dimensions of economic need in the typical Opportunity Zone. While not a panacea, this incentive could become a powerful new tool to reverse local decline and promote inclusive growth if it is deployed in a thoughtful and strategic manner. No incentive is, by itself, a placemaking strategy.

Early implementation success

Treasury deserves significant credit for the way it managed the first phase of implementation: the designation of Opportunity Zones nationwide. The statute gave governors 120 days to submit nominated census tracts to Treasury for approval. Meeting this tight deadline in a thoughtful and orderly fashion required a herculean effort on behalf of governors, their staffs, and their local partners—as well as officials within the Treasury and the CDFI Fund. All parties involved rose to the challenge with enthusiasm and a real sense of mission and possibility. Treasury ensured that eligibility criteria, an impressive mapping interface, and instructions for submission were all made available to governors well ahead of the deadlines. Treasury was responsive throughout the process and certified the selected tracts in a timely manner. It was federalism working at it smoothest, just as I am sure Congress intended. The success of that first phase of implementation helped accelerate the grassroots momentum and interest we see around the country today.

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[3] Theodos, Brett, et al. *Opportunity Zones Investment Score Dataset*. Urban Institute. Opportunity Zones: Maximizing Return on Public Investment.

Looking ahead to proposed rulemaking: ensuring new and small businesses can benefit

Since Opportunity Zones became law, the response among community leaders, state and local officials, private sector investors, and other stakeholders has been precisely what Congress envisioned. Congress understood that for the incentive to reach a wide array of places, it needed to be flexible enough to draw in a wide array of investors, who, in turn, could deploy capital to meet a range of local needs. To date, the broad and intense interest from stakeholders reflects the ambitious goals of this policy.

So, what will it take to turn interest into action? While there are many factors in play, the potential of Opportunity Zones hinges first and foremost upon timely and effective regulatory rulemaking. Investors have yet to receive the formal guidance or regulatory clarity needed to inform their decision-making. As a result, the market is not yet responding at scale and capital largely remains on the sidelines—even as the clock is ticking for this perishable incentive. However, additional clarity appears to be coming soon, as the first round of proposed rulemaking is now under review in the Office of Information and Regulatory Affairs (OIRA).

As I noted earlier, successful implementation will require rules that are fundamentally geared to facilitate investment in operating businesses. To that end, Treasury must address the following threshold issues early in the rulemaking process:

- **Definitional clarity:** The statute gives Treasury broad latitude in defining a handful of critical terms in a manner appropriate for carrying out Congressional intent, including definitions pertaining to the eligibility of a Qualified Opportunity Zone business and the nature of a qualifying investment. These rules must be designed with practical considerations and basic market flexibility in mind. If too narrow in scope or impractical in nature, the rules would undermine the very purpose for which this incentive was created.

- **Timing clarity:** Qualified Opportunity Funds (QOFs),[4] the vehicles through which all Opportunity Zone investments must be made, were intended to encourage broad participation by allowing multiple taxpayers to pool their resources and spread the risks and costs of investment across a portfolio of businesses or business properties. Funds, however, need adequate time to raise capital, conduct due diligence, and build their initial portfolio of investments. Treasury's rules should include an "on-ramp" period that allows newly-formed Funds time to conduct these activities.

- **Benefit clarity:** The Qualified Opportunity Fund structure is one of the most important features of the Opportunity Zones incentive precisely because it is key to facilitating investment in operating businesses. The statute links the benefit to a taxpayer's investment in a QOF over a duration of time, rather than a QOF's holding in any particular investment. As noted above, Congress intended QOFs to have the ability to

[4] A Qualified Opportunity Fund must invest at least 90 percent of its assets in Qualifying Opportunity Zone business stock, partnership interest, or business property.

operate as true portfolio funds – allowing investors to achieve greater scale and mitigate risk by pooling capital together and deploying it in a variety of investments. Furthermore, Congress anticipated that a QOF would not necessarily hold each of its portfolio investments for the entire duration of the Fund, but would instead make initial investments and then seek to reinvest later as capital was returned to the Fund from the sale of an asset. This again is critical for QOFs that intend to invest in operating businesses – particularly new businesses – which are inherently less predictable than real estate projects. Treasury's rules and guidance should affirm that Fund-level "churn" does not interrupt the tax benefit to an investor in a QOF.

These issues are central to the success of Opportunity Zones. Until they are addressed, a significant share of interested investors will remain on the sidelines, investment in operating businesses within the zones will be muted, and the overall scope and diversity community impact will be limited. I stress this point because federal policies have a generally poor track record when it comes to boosting private investment in operating businesses – especially early stage ventures. My primary hope for Opportunity Zones implementation – one shared by state and local officials,[5] community organizations, and investors alike – is that it will succeed where other policies and programs have fallen short: by providing a true lifeline to entrepreneurs in underserved and overlooked areas of our country. I firmly believe this goal is within reach.

Thank you, and I look forward to taking your questions.

[5] The United States Conference of Mayors, The United States Conference of Mayors to The Honorable David J. Kautter, Received by U.S. Department of the Treasury and David J. Kautter, 23 August 2018. Letter. https://www.novoco.com/sites/default/files/atoms/files/request_for_guidance_082318.pdf