Moving Beyond Flawed Critiques Of the O-Zone Incentives

by John W. Lettieri

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Opportunity Zone tax incentives became law as part of the 2017 Tax Cuts and Jobs Act. The underlying legislation, the Investing in Opportunity Act, was introduced in 2016 and enjoyed broad support from congressional Republicans and Democrats representing a wide spectrum of communities. The concept behind O-Zones is fairly simple: Encourage investors to reinvest their capital gains into long-term equity investments that support the local economies of low-income areas throughout the country, many of which had been left behind by the uneven recovery from the Great Recession. While certainly not the first example of a tax incentive designed to spur private investment in low-income communities, O-Zones were novel in design, scope, and flexibility — and therefore something of a policy experiment in how to get investors to pay attention to underserved parts of the country at a time when wealth and investment were concentrated in high-performing locations.

Although over three years have passed since O-Zones became law, the policy remains in its early stages. O-Zone designation did not occur until the summer of 2018, nor did the means for qualified investment funds to be certified. Final regulations weren’t released until December 2019. Only months later, the COVID-19 pandemic swept across the United States, causing massive loss of life and shuttering down the economy, resulting in a deep disruption to the fledgling O-Zone marketplace. We are only just beginning to see credible — although still woefully incomplete — data emerge on how and where O-Zone investments are being made. Nevertheless, some observers have already made up their minds about how the experiment will play out. One of the more notable examples of this is an article by professor Calvin H. Johnson that appeared in Tax Notes Federal last October.

Johnson’s critique rests on discredited notions about the relationship between new housing supply and the displacement of low-income people from their communities, as well as a deep misunderstanding of the design of the O-Zone incentive and how it is being used throughout the country. On all counts, his arguments deserve a detailed response.

Communities Designated as O-Zones

But let’s first examine the kinds of places designated as qualified Opportunity Zone communities, where certain types of private investments are eligible for tax benefits. As readers may know, the law gave governors of each state the authority to nominate up to one-quarter of their low-income census tracts for O-Zone status, using the same general definition of low-income that was codified in the new markets tax credit program established two decades ago. This process resulted in a map of designated communities that are on average much lower in median family income with a much

higher poverty rate than both the nation as a whole and the universe of low-income census tracts that governors did not nominate. Notably, only a very small portion of O-Zone neighborhoods — less than 4 percent, according to two separate studies — were experiencing the kind of rapid socioeconomic change often associated with gentrification at the time of their designation, which speaks to the fact that quick turnarounds in low-income areas are relatively rare.\(^3\)

Compared with the country overall, O-Zone tracts are on average nearly twice as impoverished, with a roughly 40 percent higher rate of joblessness among adult residents and a 35 percent lower median family income. Perhaps most sobering: The average life expectancy of an O-Zone resident is nearly three and a half years shorter than the national average. Residents of designated communities disproportionately bear the brunt of lingering environmental hazards, with nearly one-third of the nation’s brownfield sites located in an O-Zone. These communities are also far more diverse, with a minority share of the population at roughly 57 percent, compared with 39 percent for the country as a whole.

To be sure, governors also included some glaring outliers in their picks — higher-income areas that qualified because of a combination of quirks in the underlying census tract data and a lack of strenuous oversight by the Trump administration. These tracts, although exceedingly small in share, have been the subject of justifiable criticism. Nevertheless, by any reasonable definition, the selection process overwhelmingly targeted places with much lower levels of economic well-being than the average American community.

**Examining the Critique**

Johnson’s case against O-Zones rests on his assertions that market-rate housing investments in low-income communities “drive out poor people by increasing rents,” and “poor people . . . get nothing but displacement from property value increases.” Johnson offers no data to support these claims, but they will be familiar to anyone following the contentious debate over housing supply, gentrification, and affordability. That is because Johnson’s article follows the well-worn playbook of modern NIMBYism, which reflexively opposes new development on the grounds that it will drive up housing costs, create too much density, change neighborhood character, or some combination thereof.

To some observers, it may seem axiomatic that new market-rate housing and an influx of new residents leads to a spike in displacement of poorer residents. Proponents of this view, including Johnson, therefore frame improvements in neighborhood quality and the well-being of lower-income residents as zero-sum propositions. In this case, Johnson is making an argument about what economists call induced demand — the phenomenon in which when the supply of something increases, demand for that thing will also increase, driving an increase in consumption. Johnson believes that the induced demand caused by new market-rate housing will lead to a surge in rents that price out lower-income residents.

Here I should note that, while the O-Zones incentive is relevant to a much wider array of activities than housing investment alone, the rebuttal that follows will predominantly address housing-related issues for the simple reason that they are the overwhelming focus of Johnson’s arguments.

**New Housing and Displacement**

To be very clear, most O-Zone communities are not ones where market demand could support the kinds of gleaming luxury towers with which Johnson is preoccupied. Most will never see the rapid socioeconomic changes often associated with gentrification in major cities — with or without O-Zone investment. But for the sake of argument, let’s take Johnson’s claims at face value. Does the empirical evidence support the idea that building new market-rate housing causes nearby rents to skyrocket and drives out vulnerable residents?

On the contrary, a growing body of research demonstrates that the construction of market-rate

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housing and the construction of affordable housing are complementary — not contradictory — tools for reducing nearby rents and preventing displacement.

For example, a recent study on the housing market in San Francisco — home to some of the most expensive property values and most restrictive land-use policies in the country — puts Johnson’s scenario to the test. This research found that new market-rate construction was associated with a reduction of rents by 2 percent in the nearby area and a remarkable 17 percent decline in renters’ risk of being displaced to a lower-income neighborhood. Meanwhile, the probability of eviction for nearby tenants of rent-controlled apartments plunged by 31 percent. The author summarized her results as follows: “These findings suggest that increasing the supply of market-rate housing has beneficial spillover effects for incumbent residents, reducing rents and displacement pressures while improving neighborhood quality.” In other words, exactly the opposite of what Johnson assumes will happen.

Other researchers have come to similar conclusions. A 2016 study in New York City found that rents decreased by 1 percent with every 10 percent increase in nearby housing stock. The supply effect of new housing drove down rents and sale prices even though it also attracted new amenities like coffee shops and restaurants, which ostensibly make the neighborhood more attractive to higher-income tenants. Likewise, a 2019 study by researchers at the Upjohn Institute and Federal Reserve Bank of Philadelphia found that the supply effect of new housing in low-income neighborhoods overwhelms the effects of increased demand and improved amenities, leading to a decrease in nearby rents of 5 percent to 7 percent relative to trends and attracting more newcomers from low-income neighborhoods: “Contrary to common concerns, new buildings slow local rent increases rather than initiate or accelerate them.” The authors’ findings can be read as a point-by-point rebuttal to Johnson’s assumptions about the effects of market-rate housing in low-income neighborhoods:

New buildings slow nearby rent increases and increase the ability of individuals from low-income neighborhoods to move to the nearby area. While the neighborhoods containing new buildings do gain richer residents, the gain is concentrated in the new building. This effectively diverts high-income individuals from outbidding low-income individuals for units in the nearby preexisting buildings. . . . Moreover, by allowing more low-income households to move to an area, new housing helps these rapidly changing neighborhoods remain economically integrated, which research suggests promotes economic mobility for low-income residents.

But what about Johnson’s alternative vision for O-Zones — one in which qualified investments would be limited only to affordable housing and therefore guaranteed not to lead to “harmful” increases in property values? Here again, the empirical evidence simply isn’t on his side. We know this because a tax subsidy exclusively for low-income housing already exists in the low-income housing tax credit (LIHTC). And, in fact, investment in affordable housing under the LIHTC has been found to raise nearby housing prices by as much as 6.5 percent in low-income neighborhoods, while also attracting new residents from a mix of income levels. Thus, according to Johnson’s “thou shalt not raise property values” commandment, Congress

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should repeal federal funding for affordable housing subsidies, too.

All of this demonstrates the folly of what urban researcher Joe Cortright calls the “myopic particularism” of focusing exclusively on “whether a single housing unit is affordable, with no attention given to affordability across the market spectrum.” To be fair, Johnson is hardly alone in this error. The idea that market-rate housing inevitably raises nearby rents and accelerates displacement — although backward — has long been treated as self-evident by many of the loudest voices in the housing debate.

Housing markets, like all aspects of a local economy, are deeply interconnected. New market-rate housing construction sets off a chain reaction involving intra-neighborhood moves, immigration of new residents, renovations to existing properties, and the development of new amenities — resulting in simultaneous improvements to neighborhood quality and reductions in the forces that lead to displacement of more vulnerable residents. New units tend to absorb the more affluent residents and newcomers to a neighborhood, relieving pressure on older, more affordable housing stock and allowing for a reshuffling akin to a game of musical chairs in which there are just as many chairs as there are players, and everyone can find a seat. Building market-rate housing on its own isn’t sufficient to preserve affordability for all residents in high-demand neighborhoods, but it is a necessary and powerful part of the equation.

Moreover, today’s market-rate dwelling is tomorrow’s affordable housing unit. It’s simple: Housing steadily depreciates as it ages, becoming more affordable relative to newer housing stock. And as Daniel Hertz notes in City Observatory, “The vast majority of homes that are actually ‘affordable’ to lower-income people are sold or rented at market rate,” but are relatively low in price because of characteristics like size or location.

The lesson is clear: Preventing displacement starts with ensuring an adequate supply of all types of housing.

Rejecting the False Choice

Now that we’ve covered the empirical evidence on housing supply, it’s worth looking more closely at the troubling implications of Johnson’s piece. His central claim is that increasing neighborhood quality and market value in low-income areas is inherently harmful to poor residents, because “they get nothing but displacement from property value increases.” If that’s true, what else could be viewed as a threat? Simple amenities, like new restaurants and retail. Upgrades to crumbling infrastructure and modernized public transit. Improvements in the quality of public schools. Initiatives that reduce violent crime and promote public safety. Grocery stores that sell quality food options. Beautification of local parks and public spaces. Remediation of environmental hazards (remember that brownfield statistic?) and repurposing of vacant or blighted structures. The list goes on and on. Every one of these can raise demand to live in a neighborhood and contribute to an increase in local property values.

Of course, it would be cruel and absurd to deny residents of low-income neighborhoods the benefits of those improvements. It is equally cruel and absurd to oppose the adequate supply of new housing. That kind of paternalistic NIMBYism only perpetuates — even justifies — the neglect and decline that plague struggling communities throughout the country.

Let’s also not forget that for most American families, a home is their largest and most important asset. Raising the long-depressed value of these assets in low-income communities is therefore one obvious way of helping to boost local wealth and close the racial wealth gap. For example, Andre M. Perry and his colleagues at the Brookings Institution have done pathbreaking research uncovering deep discrepancies in how homes are valued between Black and non-Black neighborhoods. They estimate that the undervaluing of owner-occupied homes in Black neighborhoods amounts to a whopping $156

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billion in missing wealth. This leaves observers like Johnson in an awkward dilemma, for one cannot simultaneously lament the undervaluing of Black communities — which are disproportionately low-income — while also opposing efforts to improve their market values and increase local wealth. Most O-Zone residents are nonwhite. There are 1.7 million Black or Hispanic owner-occupied units within these communities, where vacancies run more than 50 percent higher than the average U.S. community, and where the median home is worth $47,000 less than the national average. And fully 28 percent of all majority-Black neighborhoods nationwide are designated as Opportunity Zones. Are we truly to believe that the best case against this policy is that it might improve the market values of communities that have faced decades of underinvestment and outright discrimination?

Fortunately, we don’t need to choose between supporting long-overdue measures to improve struggling neighborhoods and protecting their residents from displacement; we can and must do both. Beyond the basic step of building enough market-rate housing supply to keep up with demand, there are many tools that can help ensure residents of transitioning neighborhoods can remain and reap the benefits of new investment and amenities. Most of these exist at the local level, such as capping property tax increases for long-term residents and helping tenants become property owners. After all: neighborhoods change. That much is inevitable. When it comes to managing that change, federal policy simply isn’t a substitute for targeted local interventions tailored to the unique needs of a community.

A Reality Check on O-Zones

Having examined the evidence and implications for Johnson’s broader argument, we can now turn our attention to how Opportunity Zones are actually designed and used. Here again, we will find that Johnson’s critiques stem from a fundamental misunderstanding of the facts.

The design of the O-Zone incentive was intended to increase investment in low-income communities, including increasing the supply of housing through the construction of new apartments and repurposing of vacant buildings, and to prevent direct displacement of tenants from existing rental units. The statute requires eligible O-Zone property to satisfy an “original use” or “substantially improved” standard. To meet the original use standard, a housing investment would generally need to be brand-new or involve the rehabilitation of a vacant building. In either case, that investment would add to the local supply of housing — without displacement. The substantial improvement test requires an investment into an existing property to spend an amount greater than the cost of the building in new improvements. Other rules preclude investors from simply purchasing an existing building and raising rents. And, while possible in theory, the O-Zone rules make it enormously costly and difficult to meet the “greater than the cost of the building” standard by tearing down or renovating an existing income-generating development and replacing it with a newly constructed or renovated property and charging higher rents (assuming local affordability rules even permitted such a scenario in the first place). Instead, investors are more likely to look for an empty parcel or vacant structure within an O-Zone to build new units, just as lawmakers intended. As a result, Johnson’s claim that the incentive “destroys” affordable housing only to replace it with higher rent market-rate housing is far-fetched as a practical matter and unsupported by any data.\(^\text{13}\)

One can, however, easily find many examples of O-Zone investments going into affordable and moderate-income rental housing through a simple Google search.\(^\text{14}\) One of those is the Phoenix Community in Columbus, Ohio, which


\(^{13}\) Even the single anecdotal example Johnson cites in his piece, a Bloomberg Businessweek article on the city of Norfolk, Virginia, turns out to be riddled with errors and grossly misleading. The city’s response can be found at StPaulsDistrict.org.


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services to residents transitioning from incarceration. Another is SoLa Impact, which is building hundreds of affordable units in South Los Angeles, an area grappling with a massive housing shortfall.

Not only is O-Zone capital helping to finance the supply of badly needed housing, but it is also making individual projects more affordable to tenants than they otherwise would have been. Here is how one developer of a mixed-use, mixed-income project in Cleveland described the effects of the incentive:

Basically, some of our investors are able to invest into this project and take less of a return than they typically would, because they have all these tax benefits from the opportunity zone. What that means is our capital stack is less stressed for dollars, so we’re able to take some of the units and charge less for them, and still pay back our investors.

Congress intended for the O-Zone incentive to be flexible enough to finance a wide spectrum of needs across a diverse range of communities. Early data and anecdotal evidence speak to the benefits of that flexibility. In addition to helping address the severe housing shortfall plaguing markets across the country, the incentive is being used to support major industrial, commercial, and mixed-use investments in an array of regions, as well as investments in non-real-estate operating businesses, such as Second Chances Farm, an indoor vertical farming start-up that provides employment and mentoring to formerly incarcerated individuals. From rural Alabama to downtown Erie, Pennsylvania, one can find O-Zone capital being put to productive use bit by bit in local economies nationwide.

## Conclusion

None of this is to say that the Opportunity Zone incentive cannot be improved. Nor is it to deny that well-informed observers can come to very different conclusions about whether place-based incentives are a good use of taxpayer resources. But any criticism premised on the notion that expanding local housing supply and improving neighborhood quality are fundamentally at odds with protecting poor residents should be discarded with great prejudice.

Instead, those who want to ensure that low-income people don’t get priced out of their neighborhoods should fight to make it much easier, faster, and cheaper to build adequate housing of all types in our communities. Restrictive zoning and land-use policies have chocked the supply of new housing and driven up prices to astonishing levels, disproportionately harming lower-income people desperate for access to housing in opportunity-rich areas. In San Francisco, for example, it costs around $750,000 to build a single two-bedroom unit of affordable housing. Federal incentives like O-Zones can help lower the cost of capital for housing investment, but they won’t solve the fundamental problem. That responsibility lies primarily with local officials who dictate the process, type, and location of new housing in supply-starved cities across the country.

No single policy can come close to solving the economic challenges facing struggling areas of the country, nor is investment in a community a substitute for direct support for low-income people and families. But the need for powerful and flexible economic development tools like the O-Zone incentive has only grown stronger since its passage, as the pandemic has wreaked havoc on many vulnerable communities and added new urgency to the task of connecting struggling areas with the lifeblood of long-term investment capital.

It’s time to ignore the catastrophizing and give this worthy experiment a chance to succeed.