CAN OPPORTUNITY ZONES ADDRESS CONCERNS IN THE SMALL BUSINESS ECONOMY?

HEARING

BEFORE THE

SUBCOMMITTEE ON ECONOMIC GROWTH, TAX, AND CAPITAL ACCESS

OF THE

COMMITTEE ON SMALL BUSINESS UNITED STATES HOUSE OF REPRESENTATIVES

ONE HUNDRED SIXTEENTH CONGRESS

FIRST SESSION

HEARING HELD
OCTOBER 17, 2019

Small Business Committee Document Number 116–051
Available via the GPO Website: www.govinfo.gov

U.S. GOVERNMENT PUBLISHING OFFICE
38–014 WASHINGTON : 2020

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CAN OPPORTUNITY ZONES ADDRESS CONCERNS IN THE SMALL BUSINESS ECONOMY?

THURSDAY, OCTOBER 17, 2019

HOUSE OF REPRESENTATIVES,
COMMITTEE ON SMALL BUSINESS,
SUBCOMMITTEE ON ECONOMIC GROWTH,
TAX, AND CAPITAL ACCESS,
Washington, DC.

The Subcommittee met, pursuant to call, at 10:02 a.m., in Room 2360, Rayburn House Office Building. Hon. Andy Kim [chairman of the Committee] presiding.

Present: Representatives Kim, Davids, Delgado, Hern, and Stauber.

Also Present: Representatives Chabot, and Houlahan.

Chairman KIM. Good morning everyone. The Subcommittee will come to order.

I want to thank everyone for joining us this morning. I especially want to thank the witnesses for being here today. Thank you so much.

America's small businesses are a catalyst for creating business opportunities and driving growth in the U.S. economy. The estimate 30 million small firms in the U.S. represent over 99 percent of all employers, and support nearly 56 million jobs.

Small businesses are vital to the well-being of many large and small communities in rural, suburban, and urban areas, and that is why we need to be enacting policies that allow small firms to thrive. One way for Congress to support small businesses is through well-conceived and targeted tax policy. In my short time in Congress so far, I have heard that small firms need a simple Tax Code, one that levels the playing field and creates opportunities to build Main Street, not Wall Street.

The tax policies that are enacted in Washington have a direct impact on the people in my district back in New Jersey and take, for example, one of the signature pieces of legislation of this administration, the new tax law.

That legislation, the Tax Cuts and Jobs Act passed in 2017, was an imperfect one. One example being the cap imposed on state and local tax deductions and the lack of parity between small businesses and corporations. Because of this change to the SALT deduction, millions across my home state have gone from receiving refunds to paying more in Federal taxes. And while corporations can still take the full deduction for their state and local taxes, small businesses that report income on their individual returns cannot. These are issues that need to be addressed right away.

But we are not here today to discuss all the aspects of the new tax law, but one provision that has a laudable goal, to spurn investment, economic activity, and ultimately, job growth in undercapitalized communities. Over the last several decades, and particularly after the financial crisis, thriving towns across the country with vibrant Main Streets have seen their local economies decimated. As part of the new tax law, Opportunity Zones were created with the intent to give preferential tax treatment for investors in economically distressed communities with the hope that these investments will lead to increased economic activity throughout the area.

At first glance, these new tax incentives appear to do what many other policy proposals and programs have attempted to failed to do, bring much needed capital, economic development, and jobs to those communities that need it most.

Unfortunately, like many tax incentives, there are opportunities for abuse and few guardrails around the program which could result in lost opportunity and thwarted congressional intentions. The overall structure of the tax incentives centered around Opportunity Zones leave many questions unanswered.

The centerpiece of the tax incentive is continued deferral of capital gains on previous investments and complete elimination of capital gains tax on gains within opportunity zones that are held for more than 10 years. While this sounds like a reasonable tradeoff, it begs the question of what sort of investments will be made, by whom, and what will be prioritized to ensure economic growth, prosperity, and job growth in the near and long-term?

And while investments can be made in virtually any business or assets, reports indicate that most of the money is flowing towards real estate versus small businesses already operating within the Opportunity Zone. When an investor buys a property, makes some improvement and sells it to someone else for a higher price while deferring capital gains, investors, fund managers, and real estate developers benefit but there does not seem to be much benefit to the broader community.

Further, with no minimum or maximum investment requirement, few restrictions on who may make investments or set up an opportunity fund and no public reporting requirements, we must determine how best to measure the success of this new tax provision to determine if it is meeting the intended goals.

And, like any new program or tax benefit, we must ask whether our agencies have the proper tools and resources in place to combat waste, fraud, and abuse. This last point is of particular importance as recent news report highlight the growing concern that Opportunity Zones are new tax incentives that only benefit those with capital that are looking to further defer and delay paying taxes on capital gains.

That is why today's hearing within our Committee's jurisdiction is so important. We need to shed light on how this new program works and does not work and what additional regulatory clarity is needed to ensure that low and moderate income communities where many small businesses operate are getting the critical investments that the new tax law promised.

It is my hope that this hearing will shed light on the possible benefits that Opportunity Zones have for small business while looking critically at our outstanding challenges and real concerns that must be addressed.

I firmly believe Congress can work together, just like this Committee does day in and day out, to find responsible tax incentives and policies that truly help small firms and strengthen our economy for the long term.

With that, I want to again thank each and every one of the witnesses for joining us, and I look forward to your testimony.

I would now like to yield to the Ranking Member, Mr. Hern, for his opening statement.

Mr. HERN. Thank you, Mr. Chairman.

Mr. Chairman, if I may, I would ask for just a moment of silence for our colleague, Elijah Cummings and his family.

If I could please, just a moment of silence, please.

Thank you so much.

It is good to be with you today. I look forward to hearing your testimonies.

As a small business owner myself for the past 34 years, including 17 years on a bank board and 13 years on the McDonald's National Leadership Council serving over 3,500 McDonald's franchisees, 8 years of that. I was the ombudsman 5 years as the National Chairman of the Systems Economic Team, 5 years on the Corporate Tax Policy Team, 8 years on the Insurance Policy Team, there is no better advocate for small business in the United States House of Representatives than myself. And so I want to look at every policy that is coming through here to make sure it actually benefits those who are asking for help.

But generating two out of three jobs in business and across America, this economy depends very heavily on small business, not only small business as we know it but also the incubators for the large businesses of the future. From traditional brick-and-mortar storefronts to highly specialized manufacturers, small businesses and entrepreneurs and startups are transferring how business is getting done these days. We must continue to work in a bipartisan manner to ensure that all small businesses operate within an environment that is free of overly burdensome regulations and an environment that allows them to create jobs and expand. That is why it is important that we are going to be discussing another bipartisan idea that has been implemented and making progress across the country: Opportunity Zones.

As a way to jumpstart economically distressed areas of the Nation, the Tax Cuts and Jobs Act included a provision to authorize the Opportunity Zones program. This program provides stepped up tax enhancement for individuals that reinvest their capital gains in targeted economic areas. Opportunity zones represent a unique working relationship between the Federal Government, state and local municipalities, and the private sector. Although similar to programs of the past, Opportunity Zones have been created with flexibility to ensure utilization.

Within my state of Oklahoma, there have been 117 Opportunity Zones designated. Moreover, approximately 380,000 Oklahomans live in these designated boundaries, and in my congressional district alone, Oklahoma's 1st Congressional District, we have 23 designated zones.

In order to direct investments properly, qualified opportunity funds must be created. Although recent headlines have suggested this program will only benefit certain business sectors, this hearing will allow members of the Subcommittee to explore how small businesses can better interact with these designated zones.

We know that small businesses are the Nation's job creators, and thus, when jobs are created in communities, neighborhoods are transformed. The two rounds of guidance from the Deparmtent of Treasury and the IRS have continued to clarify the roles of businesses within this program.

The first round of regulations was published in October of 2018 and the second round came out in April of 2019. With the program in its infancy, we need more information on how investments are being shaped and on how dollars are falling to projects. This information will be critical as we assess its effectiveness.

I look forward to hearing from our witnesses on how this program has been implemented and the steps that have been take to spur economic development. I know this hearing will provide even more clarity for small businesses across the Nation.

And with that, Mr. Chairman, I yield back.

Chairman KIM. Thank you, Mr. Hern. The gentleman yields back.

And every time we have one of these hearings I am always reminded about how grateful we are and lucky to have your expertise as a small business owner and someone who can really help make sure that we focus in on where the rubber hits the road and make sure we can get things done, which is very much the intention of this Subcommittee. The Ranking Member and I both want to make sure that we can move forward just thinking about what is best for the small businesses and we come into this hearing with an open mind, just really trying to get at the best understandings of what we have seen so far, trying to glean best practices, and trying to understand where we might be able to go from there to the benefit of small businesses, whether in Oklahoma, New Jersey, or elsewhere around this country.

And if Committee members have an opening statements prepared, we would ask that they be submitted for the record.

I would like to just take a quick minute to explain the timing rules. So each witness will get 5 minutes to testify and the members get 5 minutes for questioning. You have a little gizmo in front of you which is our lighting system. The green light will tell you when you begin. The yellow light comes on when you have 1 minute remaining. And the red light comes on when you are out of time, and we ask that you do your best to stay within the timeframe to the best of your ability.

I just want to quickly introduce our witnesses before we proceed. I would like to introduce Mr. Brett Theodos. He directs the Community Economic Development Hub at the Urban Institute where he is a senior fellow in the Metropolitan Housing and Communities Policy Center. His work focuses on economic and community development, neighborhood change, affordable homeownership, consumer finance, and program evaluation and learning. Thank you for coming.

Our second witness is Mr. Aaron Seybert, the managing director of the Social Investment Practice at The Kresge Foundation. Prior to joining the foundation in 2016, Mr. Seybert served as executive director at JPMorgan Chase Bank where he was involved with community development banking focused on new market tax credits and historic tax credit investing. Welcome, Mr. Seybert.

Our third witness today is Ms. Jennifer Vasiloff. She joined the Opportunity Finance Network (OFN) in 2017 as chief external affairs officer, a role capitalizing on her 16 years of experience in promoting and strengthening the CDFI field. Ms. Vasiloff leads the organization's efforts to raise the profile of CDFIs, particularly at the national level. Welcome, Ms. Vasiloff.

I would now like to yield to our Ranking Member, Mr. Hern, to introduce our final witness.

Mr. HERN. Thank you, Mr. Chairman.

Our witness is John Lettieri. Mr. Lettieri is president and CEO and cofounder of the Economic Innovation Group, also known as EIG. EIG is a leader on economic policy matters and an innovator of policy solutions that power America forward. Mr. Lettieri has previously served as a staffer in the United States Senate and is a vice president of Public Policy and Government Affairs for the Organization of International Investment with a focus on economic development. Mr. Lettieri has also testified in the past on Capitol Hill on the topics of Opportunity Zones. Mr. Lettieri, we appreciate you taking time away from your company to talk with us today. Thank you.

Chairman KIM. Great. Thank you so very much. And again, we are grateful to have all four of you here today.

Why do we not just jump right in? Mr. Theodos, you are recognized for 5 minutes.

STATEMENTS OF BRETT THEODOS, SENIOR FELLOW, URBAN INSTITUTE; AARON SEYBERT, MANAGING DIRECTOR OF SOCIAL INVESTMENTS, THE KRESGE FOUNDATION; JENNIFER A. VASILOFF, CHIEF EXTERNAL AFFAIRS OFFICER, OPPORTUNITY FINANCE NETWORK; JOHN LETTIERI, PRESIDENT AND CHIEF EXECUTIVE OFFICER, ECONOMIC INNOVATION GROUP

STATEMENT OF BRETT THEODOS

Mr. THEODOS. Chairman Kim, Ranking Member Hern, and members of the Committee, thank you for inviting me to speak with you today.

I study private and mission and public financing to understand who communities are accessing capital, which are being left behind, and how to help. These I offer on my own, not to be attributed to the Urban Institute, its trustees, or funders.

It is a legitimate work of the Federal Government to help communities inadequately connected with capital markets achieve economic growth. We have many examples of Federal programs and incentives working to achieve those ends. However, we also have

1031 exchanges and the mortgage interest deduction and EB5 visas that are poorly targeted to need.

Community development policy in the United States, 2 or more generations ago consistently relied on Federal spending and control, but we have gradually and consistently moved towards a model where the Federal Government exerts less and less control over Federal resources. I submit that Opportunity Zones mark the near complete transition to privatized Federal community economic development policy.

A heavy reliance on the private sector to accomplish the public agenda introduces a set of pitfalls. While some zones should never have been chosen or eligible, many do show real need for investment and OZs will undoubtedly attract substantial capital into zones in aggregate.

OZs have four compelling features as I see them. They tap into a new investor pool, they can be used as a tool for mission-driven projects, they encourage a longer term investment horizon, and they incentivize equity capital which receives less Federal attention.

However, as currently structured, OZs have several shortcomings. Their place-based targeting is overly broad with too many upper income communities included. For example, zones in Manhattan and Brooklyn and Berkeley where the median home is worth more than a million dollars.

Real estate will be the largest use case and there are already better targeted Federal supports for real estate. There are not sufficient project type or use requirements in contrast with other Federal tools. So, for example, no requirements that new apartments be rented at affordable prices. There is no requirement for community input or engagement under this new incentive. Many OZ investors report they would have done the deal in the exact same form absent the incentive, meaning the Federal Government is subsidizing projects that do not actually need the help. And finally, there is a lack of reporting requirements.

Congress should consider the following reforms:

First, tighten the number of eligible zones by removing all contiguous tracks, as well as those that as they gain investment stop qualifying as low income communities.

Second, Congress should more narrowly restrict qualifying investments. For instance, only real estate transactions where the operating business is the owner occupant or where housing is sold or rented at below market prices.

Third, any investment into a CDFI, a community development financial institution, any investment into a vehicle that they control should be given preferential treatment.

Fourth, Congress should add a "but for" or a substitution test to restrict the incentive to projects that could only proceed with the additional help.

Fifth, Congress should consider restructuring the tax benefits by extending the temporary deferral, by converting the step-up and basis to a sliding scale that depends on the level of economic distress in the zone, and by eliminating the permanent exclusion.

Finally, Congress should require transaction level reporting for all OZ investments on who, what, where, when, and how much. So who the investors and the investees are, what the investment was for, when the investment was made, where the investment went, and how much was invested.

It is important to note that Treasury could improve this incentive even now, but if Treasury fails to take these steps, Congress should act. Treasury could make this more like a program, not merely an incentive by giving responsibility to a sub-agency with dedicated staffing to oversee data collection monitoring. Treasury should conduct a rigorous certification process for opportunity funds to be eligible to act as an investment vehicle, providing a mission test for opportunity funds, not self-certification. And finally, the draft IRS tax form is inadequate to track the program but Treasury already has the authority it needs through the certification process.

Thank you for your time. I look forward to questions.

Chairman KIM. Thank you so much.

Mr. Seybert, over to you for 5 minutes.

STATEMENT OF AARON SEYBERT

Mr. SEYBERT. Thank you, Chairman Kim, and Ranking Member Hern, and members of the Committee.

The Kresge Foundation is a $3.7 billion privately endowed foundation headquartered in Metro Detroit working nationally. We are focused on creating opportunities for low-income people in America's cities. We raise no outside capital. We provide no for-profit services. We have no stake in Opportunity Zones whatsoever other than the $22 million of balance sheet protection we have provided to two Opportunity Zone funds that are mission aligned with our organization. Our sole focus in the sector is ensuring that Opportunity Zones benefit low-income people.

In addressing the concerns of the Committee, I would like to suggest that we focus on maybe a different question than has been presented because I think certainly Opportunity Zones can address the concerns of the small business economy. The question really should be will the new marketplace that has been created do that, and what incentives exist for the market to address those concerns?

As Brett mentioned, unlike virtually every other Federal incentive designed to address inequality, this is not a program. This is a private marketplace that is entirely unregulated or virtually unregulated where private investors deploy capital gains, grow those gains hopefully in return, invest those gains in Opportunity Zones in hopes of growing those gains long term and avoiding capital gains in the future. How those gains are invested and who benefits from those investments remains largely undefined.

Given that understanding, I think that we should examine the existing capital challenges that face small businesses in this country every day. Particularly for minority-owned firms, many small businesses struggle to access capital because they are undercapitalized to begin with. The lack of equity in small businesses makes it difficult to access traditional debt products needed to grow and expand. Here, Opportunity Zones could really provide a great benefit.

The incentive requires investors to make equity investments in underlying businesses. In a traditional venture capital model where venture investor returns are really enhanced by this incentive, that rationale make a lot of sense in how the tool is effective in promoting that sort of investment. What is unclear though is whether or not the incentive is there to invest in small businesses that do not offer the same growth curve like a tech company provides. Many small businesses do not appreciate capital in that fashion. They are oftentimes illiquid and it is unclear as to how an investor would exit their investments in a small business if not for a venture-like or private equity-like model.

That brings me to my second point which is really around scale. If you examine the 75, 85-ish so sort of privately declared opportunity funds who have decided to identify themselves as such, the majority of those require a minimum investment of $250,000 of investment, and many are significantly more than that. When you compare that to the data around small businesses, which again, definitionally, it is important how you define small businesses, but in the data that we look at, most businesses are seeking growth equity less than $250,000, certainly, and many under $100,000. I think that mismatch creates a problem for many small businesses where the market is trying to deliver a product of scale and many small businesses need something that scales down to the business needs on the ground.

Third, we want to understand the risk-return calculus for investors. It has been noted, real estate is the predominant asset class right now in the opportunity's own sector because we believe that real estate generally provides a lower risk, an enhanced risk calculus for investors. And so while small businesses certainly can absorb capital from opportunities on investors, the question is why would an Opportunity Zone investor, but for the venture capital model, decide to take the risk of a small business when real estate, generally speaking, is acknowledged as being a lower risk moderate return investment class. And so it is unclear as to why investors would choose to take that additional risk.

Knowing the structural issues that sort of face small businesses and the way that Opportunity Zones overlay, it is really impossible to know whether not Opportunity Zones today are going to address the concerns of the small business community. Because of the way the legislation was structured, there is no disclosure accountability built into this marketplace. The public is likely to never know who raised the capital, where it was invested, and who benefitted from that investment. It is like the transparency should be concerning to all of us because as we learned in 2008-2009, markets without transparency are not only inefficient but they can also be dangerous.

So we truly believe that Opportunity Zones offer a huge potential to the communities that we are concerned about, but until we have that transparency in the marketplace that is needed, we are going to be very concerned about the impacts on our constituencies and the people that we serve every day.

Thank you for your time, and I am happy to answer questions.

Chairman KIM. Great. Thank you for your comments there.

Over to Ms. Vasiloff. You are recognized for 5 minutes.

STATEMENT OF JENNIFER A. VASILOFF

Ms. VASILOFF. Opportunity Finance Network (OFN) is a national network of community development financial institutions (CDFIs). CDFIs are mission-driven community development banks, credit unions, loan funds, and venture capital funds investing in opportunities that benefit low-income, low-wealth, and other underresourced communities across America.

Currently, there are more than 1,000 CDFIs certified by the Department of the Treasury's CDFI Fund. Nationwide, the CDFI industry manages over $185 billion in assets. With cumulative net charge-off rates of less than 1 percent, CDFIs lend prudently and productively in markets often overlooked by conventional financial institutions.

CDFIs are the "boots on the ground" experts that have been operating in Opportunity Zones and other disinvested communities for decades. As soon as the Opportunity Zone provision became law, CDFIs across the Nation began reaching out to investors, community residents, and other partners excited about the potential of this new community development tool. Many CDFIs devoted significant resources to exploring how to attract Opportunity Zone investors to the projects with high-mission impact that CDFIs specialize in.

Regrettably, we have found that the Opportunity Zone tax incentive is not a good match for the kind of neighborhood revitalization deals of interest to CDFIs, particularly those targeting small businesses. Our member CDFIs tell us that investors expect double-digit returns, prefer real estate to small business investments, and largely shun the more challenging areas that need an infusion of capital the most. As a result, relatively few CDFIs are moving forward with establishing their own Opportunity Funds. Among those that are, an even smaller number are planning to concentrate on investments into small businesses.

The structure of the Opportunity Zone incentive is better suited to investing in a new business choosing to locate in an Opportunity Zone, rather than a business already operating in the community.

As important as launching a startup venture might be, the health and growth of existing businesses is also critically important, particularly businesses that employ community residents.

Two CDFIs that are trying to use the Opportunity Zone incentive for small business investment are Community Reinvestment Fund headquartered in Minnesota and targeting the Midwest for their opportunity fund, and AltCap, a CDFI serving the Kansas City market. These experienced small business CDFIs are launching Opportunity Funds with a goal of investing in operating businesses. OFN strongly supports their efforts and looks forward to highlighting their work. However, both organizations have encountered obstacles and face competition from Opportunity Funds that are not as mission driven or focused on the small business community.

Separate from the limited role the CDFI industry is likely to play, OFN is concerned that community residents, Congress, and other stakeholders will have limited information on how the Opportunity Zone tax incentive has operated due to the anemic data collection currently required by the Internal Revenue Service and U.S.

Treasury. OFN has advocated for comprehensive data collection that will show where an Opportunity Zone investment is being made, the results of the investment, and the impact on the targeted community. The modest level of data collection currently planned by Treasury should be significantly expanded to get the full picture of the impact of Opportunity Zone investments.

In the absence of an adequate Federal data collection protocol, OFN contributed to and strongly supports the Opportunity Zone framework, a voluntary set of guidelines created in partnership with the U.S. Impact Investing Alliance, the Beck Center at Georgetown University, and the Federal Reserve Bank of New York. The framework identifies best practices, a reporting framework, and a shared goal of measuring outcomes. My colleagues, the Kresge Foundation, Urban Institute, and Economic Innovation Group are all contributors to the framework.

OFN also supports the bicameral, bipartisan legislation that has been introduced to establish reporting requirements for Opportunity Fund investment.

In summary, the Opportunity Zone incentive is a poor fit for CDFIs, a missed opportunity to take advantage of the experience, mission commitment, and expertise of this nationwide network of community development finance professionals. Unfortunately, new investments in small businesses incentivized by the Opportunity Zone tax benefit are likely to be disappointing also.

OFN encourages members of this Committee to support stronger accountability measures in the Opportunity Zone program and to consider other approaches to foster small business development in underinvested communities, including those leveraging the Nation's network of community development financial institutions. Thank you.

Chairman KIM. Thank you.

Why do we not go on to our final witness here? Mr. Lettieri, you are recognized for 5 minutes.

STATEMENT OF JOHN LETTIERI

Mr. LETTIERI. Thank you, Mr. Chairman and Ranking Member for inviting me to testify.

EIG was the leading proponent of the concept behind Opportunity Zones, and I believe it can provide a new lifeline to struggling communities if implemented properly.

While there have been a number of Federal incentive programs aimed at boosting economic activity in underserved areas, Opportunity Zones is a sharp departure from past precedent in its scope, flexibility and its structure. Perhaps for this reason it has generated enormous interest from a wide variety of stakeholders.

While the incentive was designed to meet a wide variety of needs, its central purposes was to support new businesses and existing small and medium-size firms in need of growth capital.

The topic of this hearing is specifically whether Opportunity Zones can help address concerns of the small business economy, and here I think it is important to distinguish between small businesses and new businesses because policymakers generally devote too much attention to the former and not nearly enough to the latter. It is specifically new businesses that grow and add employees to which most net new job creation can be attributed each year. It should therefore be of concern that new business formation was abysmal in the wake of the Great Recession, both in terms of the start-up rate and the number of new firms created, as well as the geographic distribution of those firms.

The latest figures on business startups show no real rebound, making entrepreneurship one of the few indicators that have failed to meaningfully improve.

Capital access is especially critical for early-stage businesses and it is noticeably weak in Opportunity Zone communities. This policy could therefore help fill an important equity financing gap and allow entrepreneurs stay in their communities to build economic opportunity and wealth for local residents.

However, we should be clear that while vitally important for growth-oriented companies, equity capital is not always the right source of financing for local businesses. No one policy can fit all needs.

I want to talk about early market activity as we see it around the country. And though it is still early in the life of this marketplace, the Opportunity Zone's incentive is already being used to support a wide range of investments across the country as Congress intended. However, most of the early investment has indeed gone to various types of real estate developments and that is for a few simple reasons. One of the main factors is that improving the built environment is often a crucial first step in bringing people and businesses back into a community. But a more pernicious factor is the fact that the regulations governing business investment through Opportunity Zones have been slow and unclear.

Investments in clean energy, broadband infrastructure, vertical farming, manufacturing industry, industrial facilities, these are all signs of the long-term potential of this incentive even if the scale of capital flow into such investments so far has been limited. Many early investments are going into basic neighborhood amenities, such as grocery stores, medical clinics, and new housing of all different types. Small cities are using Opportunity Zones to build or expand local innovation districts or revitalize blighted downtown corridors. Several early investments are using real estate development to support a stronger startup ecosystem through incubators and co-working spaces.

Examples like these will likely proliferate as rules and best practices for Opportunity Zones become more widely understood among communities, investors, and local businesses. However, without additional regulatory clarity, and much stronger local implementation efforts, this policy will not reach its full potential. Indeed, regulatory concerns are keeping many investors who would wish to deploy capital into operating businesses on the sidelines.

Unresolved technical issues include how to satisfy the requirement that investments in existing business add substantial new value. Timing requirements governing the investment activities of an opportunity fund. How to unwind an opportunity fund and return capital to investors after the 10-year holding period. The ability to recycle capital from one investment to another without interrupting the intended tax benefit. These are fundamental issues that still remain unresolved nearly 2 years into the law's life. So it is no wonder then that the investment scope and scale is limited, particularly for businesses which are less predictable and more complicated than real estate investment.

Each of these issues will significantly impact the extent to which this policy lives up to its potential to boost investment in local businesses and create new economic opportunity for residents.

In conclusion, in spite of those challenges, I believe Opportunity Zones is a promising new initiative but it will require substantial new work, additional work to achieve its intended purpose. Let's be clear-eyed about those challenges. Rulemaking is not yet complete. Community stakeholders lack resources and are still finding their footing. The philanthropic sector, which could be playing a much more meaningful role, has been slow to engage. And investors generally remain hesitant to invest and make long-term commitments in areas where they previously might not have considered investing.

That this is hard work should come as no surprise. As a country, we have largely neglected the underlying challenges of disinvestment and declined that this policy was intended to address. There will be no overnight success stories, but with the right tools and a much greater commitment of resources I believe Opportunity Zones can be an important first step in a new movement of place-based policymaking.

Thank you. I look forward to taking your questions.

Chairman KIM. Thank you. And we appreciate everything that you shared with us. And we will jump into questions.

I will start by just recognizing myself for a few minutes here and then we will quickly move on to some of my colleagues.

We are here today as we said to talk through some of the imperfections in this system, try to shed light on how we can move forward. Certainly, it is something that is of high interest in my own district. We have six zones in my district, 18,000 residents within those zones.

There is a saying in management that you cannot manage what you cannot measure and one concern that I have had about the Opportunity Zones is the lack of established reporting requirements that do not necessary provide us with a great measure of success. And we walk a fine line here because we also want to make sure that while ensuring accountability, it is not so much that it suffocates the program or the effort that we are trying to get in. That is something that Ranking Member Hern and I have both really committed to is really just trying to make sure that we are not overly burdening especially small business and others. But we also are just trying to think through this.

So I think for me, what I would like to ask you is, as we are trying to think through, we will get to the point about what kind of information you think we would need to know, but I would like to just start are the more fundamental level. How would you measure success of this new tax incentive? How would you go about doing that? Is this something that we should look at in terms of job creation of economic growth within these communities or is there some other measure? I am kind of first interested in seeing what would you look at to be able to then come back and tell us down the road that this has been successful?

So if you do not mind, maybe we will just start with you, sir, and we will move on down.

Mr. THEODOS. So I think in terms of intermediate outcomes and longer term outcomes. And my key intermediate outcome is where is the OZ capital going? And if the OZ capital goes to the 10 percent off best off zones, if 90 percent of the capital goes to the 10 percent best off zones, then we are in a situation where we can already articulate that this incentive is not working well. If what we see is a broad diffusion of capital across all of the zones and even the most disinvested zones are benefitting from this incentive, then we are set up in a position to believe that this might be helping in a broader and more meaningful way. We do not have the insights at all to be able to answer those questions. So those are my intermediate.

Longer term outcomes are also fairly clear and straightforward. It is about job growth. It is about firm creation. It is about wealth creation for residents in communities that have historically lacked access to wealth.

Chairman KIM. I do not know if everyone wants to comment on this but just go down the row if anybody else wants to say anything on this.

Mr. SEYBERT. I mostly agree with Brett, although we come from the position of what is in the interest of low-income people. And so ultimately for us, when we think about economic inequality, it is really about the economic mobility of low-income people, right, which is really about real wage growth in low-income households. As noted, the lack of transparency makes efforts nearly impossible, and it is lacking data. It is almost entirely a long-term analysis.

I think what I would urge the Committee to reject is the false equivalency between the lack of access to capital contributing to the anemic growth in businesses which is absolutely true. And therefore, more capital must then cure that anemic growth. I do not think that we can say that. If that were true, if more capital meant more growth, then folks in all of your districts would be screaming for more subprime lending in their communities. Right? We moved billions of dollars of subprime lending through low-income communities across this country and it did not help; it hurt. Right? So it is not about the volume of capital that moves through. It is about the kind of capital that moves into these communities and who it is designed to benefit.

I do not have a short-term answer about how we measure that. I just know what has worked in the past and we have some examples of more program-like Federal programs, like the Low-Income Housing Tax Credit, the New Markets Credit, Federal Mortgage Insurance, other things that have been designed to help low-income people that over a long period of time have shown some success in encouraging economic mobility. This tool may become the thing that really drives economic growth from a household perspective, from a low-income people perspective, but it is far too difficult to tell, and without the data that has been urged to be collected by the folks testifying today, I do not know that we will ever get that answer.

Chairman KIM. Okay. Just in the short time we have, if any last comments from the two of you and then we can get back to this after we talk to some of the other colleagues.

Ms. VASILOFF. Just very briefly to sort of double down on the need for really any data collection. It is hard to define success or measure success when so little information is being asked of participants in this program. And as Aaron mentioned, there are other examples, like the New Markets Tax Credit where participants in that program are required to provide a lot of information on a transaction level basis. Systems are in place. CDFIs abide by them as well as other participants in that particular program. I think something comparable could be put in place for Opportunity Zones.

Chairman KIM. Okay.

Yes?

Mr. LETTIERI. If I could just briefly, I want to mostly agree with what everyone said and strongly disagree with a couple things.

One, I think we all agree on the need for reporting requirements. That is something that EIG has led the charge on legislatively and in our comment letters to Treasury. So there is no disagreement I think on this panel about that.

However, I think we are better off looking at this as a policy experiment in light of the large-scale failure of many other programs with a similar intention and somewhat similar structures to each other to achieve the intended results of stimulating widespread and large-scale economic growth in those low income areas. We do not really know at scale what works particularly with this new policy. And so you do not just at the Federal incentive. You look at what are communities actually doing. Let's not ignore the fact that states and localities have a vast toolkit if policy and regulatory tools. There are local anchor institutions and partners and philanthropies that can play a part and we cannot judge a place that had none of those assets activated in the same way that we judge a place that had all of those assets activated on behalf of their Opportunity Zone strategies. So we need to look at what places are actually doing to implement locally what is at its best a powerful Federal tool, but one that does not have any kind of mandatory uptake. A community can choose to use it or not. They can choose to have a strategy or not. And if they do not, we should naturally then expect weaker results in those communities.

Chairman KIM. Okay, great.

Hopefully, we will get to do a second round of questions but I just want to quickly hand it over to my Ranking Member to follow up.

Mr. HERN. Thank you, Mr. Chairman.

There is so much to talk about here. I have, as I mentioned, 23 in my district. I live within 5 miles of 19 of those. And being a long-term investor and developer in real estate, small business owner, I am always looking like any entrepreneur would be, what is the next opportunity?

I do agree where the successes are coming, or where at least obviously it is a very short window here we are looking at, but just anecdotally seeing who are investing in these areas. There are large real estate plays. One would have to ask why these areas became blotted, which many of you all in this area you look at that and you say a lot of this, there have been people moving out of these areas where newer neighborhoods are developed. Crime is driving a lot of this. Changing in traffic patterns, road development or lack of development, loss of jobs, many, many things. One would argue that to bring these, revitalize these neighborhoods or these particular OZs would be to bring business back in which is why we are talking about this today. I have always said that most people do not move to a city or to an area because small businesses grow. It is usually a larger business, and small businesses are those who service the employees that work at those larger businesses.

So there is a lot to digest in all of this. Again, I have looked at this, I have shared this with our staff. I have looked at this since the moment it was launched, and I have talked to many, many colleagues, including tax attorneys and fellow developers and it has been very interesting to try to figure out how to make these work personally.

But with that said, I would like to start with you, Mr. Lettieri. Can you just give us any examples where people have invested in the qualified opportunity funds and how those are being invested in small businesses?

Mr. LETTIERI. Sure. I think there are a couple of examples I would point to.

One is we see some interesting sectors emerging with Opportunity Zones in use. One of those is vertical farming. So you see there have been a number of vertical farming companies and businesses that have started up either to invest in that sector or as businesses qualified for opportunity fund investment. And so that seems to be a sector that in the early stages with the limited regulatory clarity that we have still nevertheless works well with the nature of the incentive.

As I mentioned in my testimony, a lot of the businesses that are seeing support from Opportunity Zones thus far are local amenities like grocery stores and medical clinics and things that we would want to take for granted in any kind of stable community. There is broadband businesses that are standing up to service the connectivity gap in a lot of the low-income areas.

So there are a lot of creative use cases in the business space that can be used. But I want to again underscore, Opportunity Zones is an equity incentive many, if not most businesses do not need or qualify for equity investment. So we have to understand that this is a tool that is going to fit a specific and very important market need, one that creates and can support growth companies. But then, as you mentioned, can support a stronger ecosystem of other small businesses and service industries that support those larger employers. What a lot of these communities lack is a real anchor kind of growth company and what is going to be required to bring them back are some stable and growing employers that can add to the tax base that can create jobs, et cetera.

To Arron's point, when we think about what benefits low-income people, we know from an emerging body of research that concentrated poverty and economic segregation is one of the very worst things, especially for a child growing up in those types of communities when you look at their long-term life outcomes. When you think about growing up in a concentrated poverty area or a distressed city, services are often lacking, schools, ambulances, fire trucks, police. Those are things that they cannot take for granted the way we can in more prosperous areas. So putting businesses and development in these areas that rebuild the tax base is also an important side benefit to the communities and to the most vulnerable residents because it creates a base of resources that they do not currently have or cannot currently rely on.

Mr. HERN. Mr. Lettieri, if I may, just with the remaining time I have here, you did allude to something that none of the other three touched on, or maybe I missed it. We try to do this a lot. I have only been in Congress less than a year now but I have seen it throughout my lifetime. We try to fix a lot of national problems or a lot of local problems with national Band-Aids, if you will. And I realize it is around the Tax Code that we do that. But it seems to me that the people and the entities that are most equipped to fix these areas are the communities, the cities that most of these areas lie or the states that they lie in. And it would seem that as we go through and we look at these that it would be important that we figure out how to include the state and the local governments in these as well in a fashion that is outside the private investment as well. Because, again, I look at these, I look at the people who are investing in these areas are very, very, very wealthy individuals. The money knows no politics. And so it is really about return opportunities.

And I look forward to listening to the rest of the questions today and us coming out here with some solutions as we go forward. But I do agree the reporting is just so critical.

Thank you, Mr. Chairman.

Chairman KIM. Great. Thank you.

Why do we not proceed? I am going to turn it over to Congresswoman Davids for her questions.

Ms. DAVIDS. Thank you, Chairman.

And I would just like to first thank the Ranking Member for acknowledging the loss of our colleague, Mr. Cummings.

I also, this is unintended but I am going to, it is like we planned it, I am going to follow up on the Ranking Member's question.

But first I want to just kind of talk a little bit about the district that I represent is the 3rd District in Kansas. And Ms. Vasiloff, thank you for in your testimony, written testimony and also your testimony in front of us here today mentioning the good work that AltCap is doing. They recently moved. Well, not moved but they have included Kansas in their service area, so I have spent quite a bit of time talking to the folks at AltCap, and they are definitely doing a lot of really good work in supporting small business growth in our community.

So I know the hope for increased investment in Opportunity Zones, it is definitely exciting and it is promising and that there are a lot of factors to consider. And oversight, especially from what we have heard today, oversight that needs to be done to ensure that the progress from this program or incentive is equitable and that it is sufficient.

The State of Kansas has 74 designated opportunity zones and those are in a lot of different kinds of areas—rural, industrial, urban, suburban. And in the 3rd District alone, we have got 11 Opportunity Zones. They are in Olathe, in Lenexa, which are both in Johnson County, and then Kansas City, Kansas, which is in Wyandotte County. And each zone and each neighborhood is dealing with its own unique set of challenges which I am sure you all are familiar with. Every community has its own unique flavor.

We want to do everything we can on this Committee to support and promote small business growth and making use of investments in the way that we can. So I will start with Mr. Theodos. You already mentioned community involvement in your testimony, and then the Ranking Member also started to bring up that concept. I am curious from you, and then everybody else, know that I have used half the time, to talk a little bit about how we can bring communities into the conversation in a more effective way, and what kind of role they need to play and at what stage because I think that oftentimes communities will find themselves trying to give input and a lot of decisions have already been made. So if you could talk a little bit about that that would be appreciated.

Mr. THEODOS. There are some fundamental disconnects that make that hard with this incentive. There is not the legal structure or mechanism by which cities or states or counties or resident association or groups can engage to have a say or even to know whether this capital is deployed in their communities. These are private investments that can happen. They need not involve public sector dollars beyond the OZ financing or community residents themselves. So residents may not know this is going on. Even if they do know they may not have any access. Sometimes cities have the ability to control zoning or other elements but not all places have that opportunity. And so it will be a challenge to think how OZs allow for any reason community engagement process in a mandatory required or even encouraged way.

Ms. VASILOFF. You know, you can use this incentive anywhere. And so you sometimes have the dynamic of communities almost competing with one another for access to Opportunity Investors investors. So in the conversations we have had with some of our members, particularly some serving rural Opportunity Zones, maybe do not have some of the other folks engaged that even a Kansas City community does have in place. And so I suspect that some of those areas are going to be bypassed by investors; but we do not know yet.

Mr. SEYBERT. I will quickly add that when I speak to mayors and governors across the country, I advise them to play both a strong defense and offensive game in regard to Opportunity Zones. Just start with the needs of your community. Understand the capital that is needed and then form strategies around that, not strategies around Opportunity Zones alone.

Ms. DAVIDS. Thank you. And I yield back.

Chairman KIM. Great. Thank you.

I will now turn it over to Congressman Stauber. You are recognized for 5 minutes.

Mr. STAUBER. Thank you, Mr. Chair, and Ranking Member Hern for putting on this discussion today. And also to the witnesses. I appreciate your expertise in the areas and your thoughtful consideration to the questions that we are asking. I have got a few myself. I will make a comment first.

Opportunity Zones are a huge deal for Northern Minnesota. With over 30 Opportunity Zones in my district alone, we are making sure rural America knows and that rural America matters. In fact, I have had the constituents ask how can they have their own town designated an Opportunity Zone since I started here in Congress 10 short months ago. The economic potential from an Opportunity Zone designation is being felt by our communities.

With all good ideas though come some challenges. To that end, Mr. Lettieri, what did Congress get right and wrong with the Opportunity Zones? And then the second question is what information is still needed to give the Opportunity Zones a chance to really be successful?

Mr. LETTIERI. Thanks for the question.

With some intellectual humility here I will say there are a lot of the answers to that question that we will not know for a while. And this underscores again the need for both patience and data.

I think one thing it got right that I think is a key differentiate between this policy and other previous programs is the flexibility and scalability of the incentive. Typical tax credit programs cap out at a relatively low dollar amount relative to the national scale of need. So if you have a $3 billion tax credit program and a couple dozen investments in low-income communities around the country, those may be great investments for those individual communities. It offers no promise of scale to be able to meet a wide array of needs in a wide array of places.

So the fact that this is non zero sum, the fact that your district and the communities in your district can benefit at the same time that other places in your state can benefit without it being as zero sum in nature as a scarce tax credit is a huge deal and I think one of the key features here. The flexibility of use case as well. The fact that you can have multiple reinforcing investments in different sectors in the same community. So housing at the same time you are investing in businesses, at the same time you are investing in infrastructure, that is really important because as we know, these communities have needs in bunches, not just one specific type of need. And if you get that kind of clustering effect, that is what we know is going to be the most effective in building a durable economy over the long term.

I think some of the weaknesses have been already noted and some of them are also inherent to any specific policy. It is not going to solve on its own really any problem except making capital access easier. It is a tool. It is not a strategy in and of itself.

To the congresswoman's question about what communities can do, one thing that really enhances the market opportunity for communities and gives them more control is doing what they should be doing anyway, which is assessing what are our needs and assets? What is our vision for how we want Opportunity Zones used? How do we pitch that to the private sector?

And about 50 cities have already done that through an Opportunity Zone perspective led by an organization called Accelerator for America which is a group of mayors around the company. That is a great way to assess what are our needs? Let's take stock of our assets. Many of these assets are publicly owned and doing nothing for the community and not presenting any value to investors either. And so activating those latent assets is a huge deal and Opportunity Zones gives us a chance to do that.

Mr. STAUBER. I appreciate the answer.

One of the things that I look at, I, too, and a small business owner going on 30 years, and so one of the things I look at is the ability to access capital. That is tough for many small businesses. But I have to just say from the three other witnesses, from this small business owner, I just felt like there were more government layers that you would like to put in place. And from my standpoint and from what I am hearing from constituents is we need rules and regulations. We need to look at the return on the investment but the additional, I think that is a disincentive. I think that the government is not necessarily the answer all the time. This public-private partnership I think has that ability. But to put the layers upon layers, we are trying to reduce the regulations as much as possible keeping in line with the return on the investment and also giving us the opportunity to look and see if it is successful. But just what I heard was just, you know, from this small business mind just over and over, the regulations and what you are asking these investors to go through, I just felt that maybe we ought to have a little bit more flexibility in allowing the investments to be made by the private partners or private capital to have an influence to hit our small businesses and the communities that need it the most.

Like I talked about the 30 communities in the district that I represent, Minnesota 8th, is extremely important. So I do appreciate your comments and your expertise.

Mr. Chair, I yield back.

Chairman KIM. Thank you.

We are going to turn it over to Congresswoman Houlahan. Over to you for 5 minutes.

Ms. HOULAHAN. Thank you, Mr. Chair. And thank you to the panelists who have come.

I represent a community in Pennsylvania just outside of Philadelphia. We have at least two Opportunity Zones in our community, and just by way of data, the median household in Coatesville, which is one of our zones, is $38,000 roughly, but people in poverty is 30 percent. Median house value there, $115,000. In the city of Reading, which is part of my community, the median household is about $29,000. People in poverty is 36 percent. Median value of homes are $69,000. And that is in comparison to my whole district which is about $84,000 in median income, 29 percent in poverty, and the poverty value of about $300,000.

I also come as a businesswoman as well, as an entrepreneur, and you all talked a little bit about some really important words. Mr. Theodos, you talked about mission-driven projects. Ms. Vasiloff, you talked about elevating existing businesses. And Mr. Lettieri, you spoke a little bit about philanthropic entities in business. And everyone, including our Chair, spoke about measuring what matters, the need to be able to measure success and to be able to know in the long term whether or not this is working.

Can you all speak to the degree that you can about your thoughts about vetting standards for the companies themselves? And let me get some specifics about that.

Recently, the business roundtable CEOs talked about the market signals that are talking about the importance of companies that are thinking about people and planet as well as profit, a shared prosperity, an inclusive economy, the importance of finding companies that are not only thinking about maximizing their shareholder value but also thinking about the triple bottom line. Is it something that you would consider as being a viable opportunity if we asked of these companies that are coming into these communities or these companies existing in these communities already, if they held to a certain standard of corporate social responsibility?

Mr. THEODOS. I would encourage the use of Federal resources to be in advancing community benefit and need. This is not simply a regulation. This is actually Federal spending. And so when we think about what we are getting out of it, we should, in fact, desire to get out of it what we should and want to benefit. And the nice part about how this was initially designed is there is a certification process in place for opportunity funds. And funds could be legitimate gatekeepers if they are certified to pick and invest in mission-driven projects. As currently advanced by Treasury, there is a self-certification process, which allows any actor to step through the door in a way that does not steer or any way direct the program or the dollars towards mission-driven projects.

Ms. HOULAHAN. Thank you.

Would anybody else like to contribute to that?

Mr. SEYBERT. I would just say quickly that while I agree that it would be nice for that to exist, we do have a voluntary framework that has been put forward by philanthropy and we put forward our own. And the uptake as a percentage of the identified industry is relatively small today. The Ranking Member mentioned the reasons that these communities are distressed to begin with, and I do not think that we should ignore the historical conditions that led to disinvestment in these communities, particularly concentration of poverty really driven by racism and discrimination in many of these places. And while voluntary frameworks are useful for those actors who want to do the right thing, and we applaud the business roundtable for taking that action, we know capital does not flow to these places. Not because these places are not worth investing. Not because there are not good ideas or smart people or growing businesses. It is because the market does not value these places. And this incentive creates an opportunity. Right? But without something further to nudge a market in the direction, you know, I fear personally that what we are going to do is reinforce those stereotypes that exist in the way that capital flows currently. And I do not see any mechanism where we sit today to address any of that inequity, particularly racial inequity in a lot of these places. So I am all for voluntary frameworks. We want every good actor to act to their fullest extent, but we believe that it may not be enough.

Mr. LETTIERI. I agree. I would be concerned about anything that adds a new hurdle to already struggling areas. So things that may sound good in intention but really come down to the eye of the beholder. So what is a mission aligned investment? There are a lot of different ways to define that.

Ms. HOULAHAN. Of course.

Mr. LETTIERI. And creating a national standard for such a wide variety of communities I think carries some potential downsides that may have exactly the opposite of the intended effect. And so it is the kind of thing where I would want to see a lot more state and local agency engagement in that kind of a process to shape the outcomes.

Ms. HOULAHAN. Do not disagree. I guess my concern is when you are talking about the taxpayers' dollar and resources that are benefitting communities, we should have some say in who gets the money and we should have say in what sort of actors they are. And I do agree that there ought to be in some ways a voluntary process there but also certainly one that incentivizes people to be good stewards to communities.

Thank you. And I am sorry, I have run out of time. I yield back.

Chairman KIM. Thank you, Congresswoman.

Just a few other questions. Why do we not do sort of a quick second round here in case anybody else has some follow up.

I will keep mine brief but building off of the first question I asked just about how do we measure the success, the reason I wanted to just ask that is it helps me kind of frame then the question of what information do we need? If the four of you are in agreement to some extent in terms of needing to have some type of information, some type of reporting, I would like to just try to leave this hearing with a better sense of what all you recommend we need in terms of the scope of that information and from who.

Mr. Theodos, you kind of went through if I remember the who, what, where, when, and how much; is that correct?

Mr. THEODOS. Yeah. There are three things that I would like to convey. First, the information needs to be collected not on the tax form because we need to get the information out. And so we need the information collected not on the tax form.

Second, what we need collected is that simple who, what, when, where, how much. Every investor ever has known those details about every investment they have ever made and so those are not cumbersome reporting requirements. Those are basic inventory tracking. So very straightforward, not cumbersome.

And then the third important step is we need this information distributed publicly so that Congress and mayors and governors and others can know, including community residents, how their Federal resources are being deployed in their district.

Chairman KIM. Yeah. Well using that as just sort of a framework for discussion, what would be the reactions from the three of you? Are you in agreement with that approach of framework? Do you think there needs to be more or less information? That would be just helpful for me to understand.

Ms. VASILOFF. I think this is an area where there is a lot of agreement. And in fact, there is a bill in the house that you all have an opportunity to support that would go a long way towards putting some of these things in place. I think all of us are supporting this legislation actively.

Chairman KIM. Okay. Same for the two of you in terms of that framework?

Okay. Well, that is helpful from my end.

Ranking Member?

Mr. HERN. Just a quick statement.

I was really pleased with the responses that we got from our witnesses today. What things, since we are short on the information, I would caution us of not trying to kill this program right off the bat here. I mean, there have been some comments made that, you know, became very political in narrative. I think you said, Mr. Seybert that the racial and discriminatory. I can think of half of mine that are not in racially discriminated areas. They are where big industry changed, move abroad, left very large vacant buildings out near the airport, industrial parks. It has nothing to do with racial discrimination or anything of that kind of stuff. So I would challenge us to please keep this on the narrow. I mean, you all have some great ideas. I think you can expect what you inspect. And as the Chairman said, it is very difficult to make hard decisions unless you really have some fact-based information. So I would challenge us.

Mr. Theodos, I think you nailed it perfectly. We have got to get this information. In our state, the lieutenant governor is in charge of managing Opportunity Zones. I think there needs to be a person that has the interest of seeing these communities grow, whether it is the mayors that can roll up locally into the state level. I do agree with you, it needs to be outside the tax process because, again, I can tell you that the largest investor in Opportunity Zones in our area is a very, very wealthy gentleman from the other side of the aisle that I am on that was not investing in those areas until these Opportunity Zones came along.

So in a free market society, capital will flow where it is incentivized to go and to get the best RY. And as long as our country is under free market principles without government interference that is what we would always hope it to be. But again, I think we do need to know who is going there so that we can adjust because currently all we are using is our census trap to define these areas which may or may not be right. Maybe we need to have additional metrics to define how these opportunity zones are laid out and designated.

So again, thank you, Mr. Chairman.

Chairman KIM. Thank you.

I agree with you wholeheartedly. I think all of us kind of hit the same points. We all have different qualitative analysis that we are bringing to the table, stories that we have heard or examples. And your insights were incredibly important. I think the Ranking Member and I are in agreement that there needs to be more, and especially on the quantitative side which I was glad to hear all four of you are in agreement of. And we will think through how best to be able to approach this going forward.

We are all aware that the places in this country that need capital investment to bring back jobs and revitalize communities, that these are incredibly important and that this will only happen if small businesses are given the chance to be able to lead the way. You can look no further than my home state of New Jersey where small businesses in my district simply need affordable access to capital and simple fair tax policy that allows them to compete against big corporations. While Opportunity Zones have the potential to do this, there are still many outstanding questions and concerns that need to be addressed.

My hope is that today's hearing allowed us to dive deeper into the subject and how we can improve any place-based policies to improve outcomes in communities that are desperately needed.

I just want to take this moment again to just thank the four of you for coming out. I am sure we will continue to draw upon your expertise and your insights on this going forward and look forward to working with you as we try to figure out what is best for our communities, for our small businesses, and some of our most disadvantaged communities in our area.

With that, I would ask unanimous consent that members have 5 legislative days to submit statements and supporting materials for the record.

Without objection, so ordered.

And if there is no further business to come before the Subcommittee, we are adjourned. Thank you.

[Whereupon, at 11:10 a.m., the subcommittee was adjourned.]

APPENDIX

URBAN INSTITUTE · ELEVATE · THE · DEBATE

A TAILORED OPPORTUNITY ZONE INCENTIVE COULD BRING GREATER BENEFITS TO DISTRESSED COMMUNITIES AND LESS COST TO THE FEDERAL GOVERNMENT

Statement of
Brett Theodos*
Senior Fellow, Urban Institute

before the
Subcommittee on Economic Growth, Tax, and Capital Access,
Committee on Small Business,
United States House of Representatives

CAN OPPORTUNITY ZONES ADDRESS CONCERNS IN THE SMALL BUSINESS ECONOMY?

10/17/2019

* The views expressed are my own and should not be attributed to the Urban Institute, its trustees, or its funders. I thank Brady Meixell for help in preparing this testimony.

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Chairman Kim, Ranking Member Hern, and members of the committee, thank you for inviting me to speak before you today on the important topic of Opportunity Zones.

I am a senior fellow and director of the Community Economic Development Hub at the Urban Institute, a leading research organization dedicated to developing evidence-based, nonpartisan insights that improve people's lives and strengthen communities. The views expressed are my own and should not be attributed to the Urban Institute, its trustees, or its funders.

I have spent my career studying federal community and economic development programs and policies, along with capital flows and investment. I have been actively engaged in Opportunity Zones from the point of initial proposals. After passage, I worked to inform gubernatorial selection.

Since tract designation, I have analyzed selected Zones, worked with local communities and governments across the country on implementation, and contributed to field-building efforts with the goal of encouraging the deployment of Opportunity Zone capital toward projects and businesses that meet community needs and yield significant social benefit.

The background and context I bring to this is having conducted, or currently conducting, evaluations of the CDFI Fund's New Markets Tax Credit program; the Small Business Administration's 7(a), 504, SBIC, and microloan programs; the Economic Development Administration's programs; and the Department of Housing and Urban Development's (HUD's) Community Development Block Grant, Section 108, Strong Cities Strong Communities National Resource Network, and Choice Neighborhoods programs. I have built a body of research on community development financial institutions (CDFIs) and other mission-based impact investors and lenders. I study private-market and public-sector capital flows to understand which communities are accessing capital, which are being left behind, and what can be done to help.

My goal with this work is to help communities, both urban and rural, that have historically lacked access to financing find the supports and resources they need to grow, and to do so in the manner that creates wealth, power, and, more fundamentally, hope for all residents.

Summary

Opportunity Zones were created to address a failure in capital markets. Communities across the country—in New Jersey and Appalachia, in Michigan and the Mississippi Delta, in the Central Valley of California and too many other areas—have faced severe economic distress and disinvestment for decades, stemming from a historic mix of limited or harmful private action, market determinations, and off-target or insufficient governmental policy. These communities have investable deals but may lack the ecosystem needed to translate ideas into funded projects. A lack of access to capital harms the well-being of community residents: it prevents aspiring entrepreneurs from starting new businesses, it pushes aside dreams of homeownership for families, and it starves communities of the amenities, services, and resources needed to thrive.

Over the past two years, Opportunity Zones have become the single most discussed piece of federal community and economic development policy. Much of 2018 was spent selecting Zones, drafting rules, and educating people about this new tool. Now that the rules regulating Opportunity Zones are becoming clearer, investors, local officials, developers, and businesses are engaging with the incentive—though, given limited reporting and disclosure requirements, we do not know to what degree. From what has been publicly disclosed, hundreds of Opportunity Funds have been created, and Opportunity Zone investment is beginning to flow. (Opportunity Funds are the legal vehicle through which investors with gains place capital in qualified businesses.) Considering their potential to attract new investors, leverage existing mainstream investors, and support mission-oriented investors, Opportunity Zones could be used to change disinvested communities for the better.

However, under the current legislative structure and executive implementation, the incentive is extremely open-ended. It lacks sufficient spatial targeting to the neediest communities. It lacks sufficient use targeting to projects that will truly benefit communities. It lacks any mechanism for community input or control. And it lacks any requirements around transaction-level reporting, though the certification process has the mechanism to permit it.

When Congress considers whether to renew Opportunity Zones, several revisions to the program would improve the flow of benefits to residents of disinvested communities—particularly those with low and moderate incomes. Legislative and administrative reforms are needed to ensure the federal government avoids subsidizing deals that don't need the support. Reforms are needed to avoid providing the lion's share of incentives to the best-off Zones. Reforms are needed to prevent taxpayer forgone revenues from being used locally in ways that taxpayers find incongruent with their objectives. And reforms are needed if this incentive is to be tracked with proper accountability.

Background

We cannot ignore the reality that wealth is growing increasingly concentrated among a smaller and smaller share of Americans. This concentration of wealth creates rigid political and social systems that threaten us all. When Hispanics make up 16 percent of adults but constitute just 6 percent of business owners, and those firms have just 1 percent of receipts, and when African Americans represent 12 percent of adults but just 2 percent of business owners, and those firms have less than 1 percent of receipts—it is a problem for all of us.[1]

It is a legitimate work of the federal government to help communities inadequately connected with capital markets to achieve economic growth and allow their residents to access the resources necessary to achieve their full potential. We have many responsible, effective examples of federal programs and incentives that work to achieve these ends. Some have been around for decades, like the Community Development Block Grant and Economic Development Administration. However, we also have programs such as 1031 exchanges, the mortgage interest deduction, and EB5 visas that are poorly targeted to communities of need.

Community development policy in the United States in its earlier days consistently relied on federal spending and control. I am no defender of previous iterations of failed place-based policy, like Urban Renewal, that displaced significant numbers of disenfranchised people, often of color. But it is worth

[1] Author's calculation based on Statistics for US Employer Firms by Sector, Gender, Ethnicity, Race, and Veteran Status for the US, States, and Top 50 MSAs, US Census Bureau.

reflecting on where we have come in our federal community economic development policymaking. We have gradually, and consistently, moved toward a model where the federal government exerts less and less control over our federal resources. Like the proverbial frog, we are no longer noticing the temperature of the water we're in.

First, in the Nixon and Ford era, the federal government devolved control of federal resources to states and cities via block grants. In the Carter era, the federal government took a further step back with Urban Development Action grants, putting the private sector much more in the driver's seat on how federal resources were used, but with HUD conducting project-level vetting and oversight. The Reagan era low-income housing tax credits continued a progression of diminished federal control, with no federal project-level vetting, but with parameters set by housing finance agencies and a competitive application process to incentivize beneficial development. The Clinton era New Markets Tax Credits were a further diminishment of federal influence and control, now with not just states, but banks, developers, nonprofits, and others deciding how federal resources are deployed, though again with a competitive process to drive behavior toward community benefit.

I submit that Opportunity Zones mark the near-complete transition to privatized federal community and economic development policy. I do not mean to set up that involving the private sector in community and economic is entirely negative—there are some real advantages. But a heavy reliance on the private sector to accomplish the public agenda introduces a new set of pitfalls and shortcomings, sometimes fundamental ones, to our policy objectives. There are opportunity costs to our Opportunity Zone spending.

What's promising about Opportunity Zones?

More than 10 million people with incomes below the poverty level, and more than 1.8 million who are unemployed, live in Opportunity Zones. Moreover, more than 21 million people of color reside in Zones. While some Zones should never have been eligible or selected, many show a real need for investment. By leveraging private actors, Opportunity Zones could become the nation's largest economic development program. Opportunity Zones will undoubtedly attract substantial capital into Zones in aggregate. And impact investors and other creative community developers will use this tool to bring benefits to some needy communities. Opportunity Zones have several compelling features, specifically that they:

- **Tap into a new investor pool**: Secretary Mnuchin estimates Zones could attract as much as $100 billion in private capital and could alter the landscape of the 8,764 designated communities.[2] Many of these potential investors could be drawn into distressed communities they have never before considered.
- **Can be used as a tool for mission-driven projects:** Under the right circumstances, Opportunity Zones will achieve positive community-driven outcomes. Some deals will revitalize severely

[2] See "Treasury Releases Proposed Regulations on Opportunity Zones Designed to Incentivize Investment in American Communities," press release, October 19, 2018, https://home.treasury.gov/news/press-releases/sm530.

distressed communities, finance burgeoning small businesses, and create new affordable and workforce housing.

- **Encourage a longer-term investment horizon:** While many factors are at play, investors often desire shorter time horizons for return than what developers and businesses are seeking. However, there are advantages for businesses in securing longer-term financing. Opportunity Zones provide an incentive for investors to place their capital gains in qualified businesses for ten years instead of the, say, five or seven years that they may otherwise prefer.

- **Incentivize equity investments:** Several federal programs encourage the provision of debt financing to businesses, but relatively few encourage the provision of equity financing.

Where do limitations, challenges, and inefficiencies exist?

- **Limited place-based targeting:** Roughly 56 percent of all census tracts in the country were eligible for designation as Opportunity Zones. Compared with eligible tracts that were not chosen, selected communities tended to have slightly lower median incomes, higher poverty rates, and higher unemployment rates, but little difference in existing capital flows.[3] But averages belie a tremendous diversity of Zones. For example, there are Opportunity Zones in Manhattan, downtown Brooklyn, and downtown Berkeley, where the median home value is more than $1 million. Yet, there is also a Zone in Youngstown, Ohio, where more than half of households live below the poverty level and the median home is worth $14,000.[4] While these are extremes, the incentive's lack of guardrails or intermediaries means capital may agglomerate disproportionately to the most economically robust Zones—as already occurs in the financial market more broadly. Moreover, the largest tax benefit in the incentive (permanent exclusion of new gains) is linked to asset appreciation: the more appreciation, the more capital gains taxes avoided.

- **Real estate will be the largest use case:** I expect real estate investments to be the clear winner over operating business investments due to relative risk, business and investment eligibility criteria, challenges with investor exits, and longer-term holding period incentives. Real estate will produce the best return in neighborhoods undergoing rapid change. This has implications for how successful the policy will be in creating jobs in disinvested urban and rural communities.

- **Lack of community input:** It is notable how little community input is required to access federal resources under this new incentive. The incentive is provided in return for equity investment in any qualified Opportunity Zone business that meets the geographic and business eligibility thresholds, is not classified as a "sin business," and fulfills the substantial improvement and other clauses. There are no stipulations in the incentive's structure for community voice or alignment with localized goals. No prioritization is given to projects and businesses that fill

[3] See Brett Theodos, Brady Meixell, and Carl Hedman, "Did States Maximize Their Opportunity Zone Selections? Analysis of the Opportunity Zone Designations" (Washington, DC: Urban Institute, 2018).

[4] Investment score and relevant socioeconomic data for all eligible and designated census tracts are available at https://www.urban.org/research/publication/did-states-maximize-their-opportunity-zone-selections.

specified capital gaps and meet designated community needs. Moreover, communities have no recourse to mitigate harm. The incentive could go toward projects or businesses that directly counteract community priorities (e.g., pricing out current residents and small businesses or contaminating the environment).

- **Lack of use-based requirements:** Eligibility requirements are minimal compared with other federal community development tools. For example, there are no requirements (as with the low-income housing tax credit) that new apartments be rented to low- or moderate-income residents; no requirements (as with the Small Business Administration's 7(a) and 504 loan guarantee programs) that federally backed investment occur only when fully private-market financing is unavailable; and no requirements (as with the New Markets Tax Credit) that investors establish an oversight board of community development experts and representatives. Not all projects will be harmful to communities, not even the majority. But some proportion will be, and the federal government has not sufficiently narrowed the eligible uses of this incentive to activities that will directly benefit low- and moderate-income residents or contribute to broader economic development in truly disinvested communities.

- **Lack of reporting requirements:** As currently proposed, IRS regulations and Form 8996 are inadequate to help community members, investors, state and local public officials, and even Congress understand this program. The draft form requires reporting at the Opportunity Fund-level, but we need transaction-level detail. Nonburdensome reporting on the who, what, when, where, and how much of any Opportunity Zone investment is crucial for judging the incentive's costs and benefits and for ensuring accountability over taxpayer dollars.[5] Much of the data about other federal programs and incentives (e.g., New Markets Tax Credits, Community Development Block Grants, community development financial institution lending, Community Reinvestment Act lending, Small Business Administration–backed loans and investments, and Economic Development Administration grants) are captured and made available. While other community development programs have sometimes required more intensive impact reporting—for example, going back years later to do original data collection about the number of jobs created for every project—I think Opportunity Zones should be treated differently. The program's effects can be sufficiently well observed and understood as long as basic transaction inventory reporting is required—and this information is shared publicly. This imposes less burden on investors than extensive original data collection. The set of facts and figures required to monitor Opportunity Zones is the very set Opportunity Funds will be tracking and collecting to analyze their own investments. These transaction-level data should be reported annually as part of an Opportunity Fund's certification process. But in addition to collecting data, The Department of the Treasury (Treasury) and the IRS must share this information widely. Without full understanding of the projects supported by this incentive, little can be done to properly assess and monitor its results for communities. With access to these data, waste,

[5] For a detailed list of recommended reporting metrics see Brett Theodos, and Brady Meixell, "https://www.urban.org/research/publication/public-comment-us-treasurys-request-information-data-collection-and-tracking-qualified-opportunity-zones" (Washington, DC: Urban Institute, submitted to the Department of the Treasury, May 30, 2019).

fraud, and abuse can be more actively reduced. A compact series of reporting requirements can satisfy multiple functions and stakeholders in one step.

Where Congress can act

The question of whether to extend the Opportunity Zone incentive will be before Congress in coming years. This decision will present an occasion to redefine the incentive in ways that ensure incentivized investments bring clearer benefit to communities. The following changes warrant consideration:

- **Remove all contiguous tracts as well as low-income tracts that no longer qualify as such**: Opportunity Zones that did not meet the low-income community threshold, but were eligible because they bordered low-income communities, are by definition not the communities in greatest need. In addition, Census tracts that, with updates to the Census Bureau's American Community Survey, no longer qualify as low-income communities, should also lose their status as Opportunity Zones. These tracts should be phased out of the Opportunity Zone incentive now for any projects not yet initiated. We need not wait until 2026 to encourage a greater flow of financing to truly disinvested and high poverty Zones.

- **More narrowly restrict qualifying Opportunity Zone investments:** Particularly for real estate investments, the legislation should be adapted to a more narrowly defined set of community needs. For instance, only real estate transactions where the operating business is the owner-occupant, commercial and industrial real estate in tracts with high vacancy rates, and housing sold or rented at below market prices.

- **CDFI priority:** Any investment into a CDFI-controlled vehicle should be given preferential treatment. CDFIs are lenders and investors vetted for their track record of and capacity for mission-based financing.

- **Only allow investments passing a "but-for" test:** Many of the early Opportunity Zone deals finance projects I have reviewed were already being finalized before the parties elected to add Opportunity Zone financing, or their sponsors report they would have occurred in the same form absent this new legislation. This means the federal government is subsidizing investments that do not need the help to go ahead. Some other federal community and economic development programs have "but for" or "substitution" tests embedded. By restricting the incentive to projects that could only proceed with the additional help of the incentive, the federal government could reduce the total cost of the incentive and reserve federal tax dollars to incentivize new development that would not have been generated by the private market alone.

- **Restructure the tax benefits:** Opportunity Zones provide investors three distinct tax benefits: temporary deferral of invested capital gains, basis step-up of invested capital gains, and permanent exclusion of taxable income on new gains. The first two incentives are more certain, and thus can influence investor behavior more predictably, spurring the new development the law intends to create. These incentives should be maintained and possibly expanded by making them ongoing (not sun-setting in 2026) or deepening the step-up in basis—but with strict conditions. The step-ups could be further targeted and differentiated by the economic distress of Zones. (For example, the step-up in basis might be 0 percent for the best-off Zones, 5 percent for the next tranche, then 10 percent, then 15 percent, then 20 percent for the most distressed Zones.) The permanent exclusion of future gains will likely be the most expensive provision of this legislation but is also the least certain from an investor standpoint and rewards speculation. Congress should consider eliminating it.

- **Require transaction reporting**: Opportunity Funds should be required to provide basic transaction-level information on the who, what, when, where, and how much of all Opportunity Zone investments made as a condition of receiving a federal tax benefit.

Where the Administration can act

Treasury has already released proposed regulations for Opportunity Zones. In the revision process, they should consider taking the following actions.

- **Make this tool more like a "program," not merely an "incentive":** An agency or subagency should be given clear administrative authority over Opportunity Zones. This work needs to be resourced. Dedicated staff are required to ensure proper oversight of Opportunity Funds and properly collect, aggregate, and share data about investments with the public. One such agency that could serve this role is Treasury's CDFI Fund, which is tasked with similar responsibilities for the New Markets Tax Credit and has thus already developed the necessary capacity and competencies.
- **Conduct a rigorous certification process for Opportunity Funds:** Opportunity Funds should be required to be undergo a rigorous certification process to be eligible to act as a vehicle for Opportunity Zone investment—not the self-certification currently advanced by Treasury. As part of this process, Opportunity Funds should be required to demonstrate an intention to and plausible mechanism for investing in projects that yield true community benefit—and to adhere to disclosure and reporting requirements and community engagement processes.
- **Require transaction reporting**: Treasury already has the authority it needs to require transaction-level reporting from Opportunity Funds that answer the who, what, when, where, and how much of all investments made. This can be done through the certification process. Reporting should be required through a mechanism separate from a tax form. (Greater difficulties arise around public reporting of data collected via tax forms.)

If Treasury fails to take these steps, Congress should revise the legislation to mandate the changes.

In conclusion

I appreciate your consideration of this testimony and welcome any future opportunity to inform Congress as it strives to ensure that Opportunity Zones achieve real benefit for communities across the country and grow the mission-based community development finance ecosystem.

THE KRESGE FOUNDATION

TESTIMONY BEFORE THE SMALL BUSINESS SUBCOMMITTEE ON ECONOMIC GROWTH, TAX, AND CAPITAL ACCESS

OF THE UNITED STATES CONGRESS

AARON SEYBERT

MANAGING DIRECTOR

THE KRESGE FOUNDATION

OCTOBER 17, 2019

Introduction

Chairwoman Velázquez, Ranking Member Chabot, and members of the Committee:

Thank you for the invitation to discuss how Opportunity Zones can address concerns in the small business economy. As you know, one of the fundamental goals of this incentive is to address disparities in access to capital for small- and medium-sized businesses located in low income communities. The Kresge Foundation's mission to expand opportunities in American cities with a focus in low-income communities strongly aligns with this goal.

In my role, I lead our nationally-focused Social Investment Practice, managing an impact investing portfolio of nearly $350 million and more than 80 transactions. Our role at Kresge is to examine why traditional forms of capital do not reach the people and communities that need it most and to create innovative financing tools that breakdown those capital barriers – all in the hopes that along the way, we unlock new sources of funding that expand opportunity.

As a charitable, private foundation, we are not subject to capital gains tax and therefore not an eligible investor for Opportunity Zone tax benefits. We raise no third-party capital, provide no for-profit consulting, accept no fees for speaking engagements, and otherwise have no economic stake in Opportunity Funds beyond what I will describe below. Our sole interest in the Opportunity Zone legislation is ensuring that, overall, this tax incentive provides meaningful benefit to the people and communities we serve.

At Kresge, we remain hopeful that this new incentive has the power to bring untold volumes of capital to disinvested communities across the country. However, we also remain deeply concerned about the trajectory of this industry and the complete lack of transparency and accountability in this newly formed market, which could inadvertently exacerbate growing economic inequality across the country.

Background on Kresge

The Kresge Foundation was founded in 1924 to promote human progress. Today, Kresge fulfills that mission by building and strengthening pathways to opportunity for low-income people in America's cities, seeking to dismantle structural and systemic barriers to equality and justice. Using a full array of grant, loan, and other investment tools, Kresge makes grants and investments of around $150 million annually to foster economic and social change.

Central to our work is the ability to draw on an array of versatile, flexible grantmaking and social investing tools. Kresge awards operating support, project and planning grants to advance the strategic objectives of its six programs. Our Social Investment Practice works across Kresge's six programs to complement grantmaking with loans, deposits, equity investments and guarantees. These funds often address funding barriers, draw other investors to the project and make capital available in otherwise disinvested communities. Typical projects include investments in health care technology, affordable housing, social service providers, Community Development Financial Institutions, social impact bonds, and real estate to advance economic development.

Kresge's engagement with Opportunity Zones

In June 2018, we partnered with the Rockefeller Foundation to release a request for letters of inquiry (LOIs) for managers establishing new Opportunity Funds. Kresge's initial purpose in issuing this LOI was to learn more about how potential managers planned to raise and deploy capital in designated Opportunity Zones. We sought potential partnerships with emerging fund managers who were seeking to deploy capital in a manner that aligned with our individual program goals and that furthered the stated goal of the Investing in Opportunity Act (the "IIOA") — reducing economic inequality.

Unlike other tax incentives designed to incentivize investment in low-income communities, the IIOA, as passed, did not include a provision for long-term impact reporting – an element we saw as necessary and important. Kresge, therefore, sought partnerships with not only mission-aligned fund managers, but also those who were willing to publicly evaluate the impact of investments over time.

We believed that in the early days of any new market there is an opportunity to define market norms, what products will come forward, and who they will benefit. We believed private philanthropy was in a unique position to help define this new market as one that not only delivers returns to investors but also creates, and does not extract, value from low-income communities. We received 141 official responses, many more than we expected.

There was a broad diversity among the submissions. Some were organizations we've worked with that would be expected to participate in community development programs of significance. But perhaps more strikingly, we saw responses from entities less familiar to us including large corporate banks, small rural communities, insurance companies and everything in between. Given that large sample, we gleaned a few early take-aways:

1. **Uncertainty about Who Will Invest**: Few managers were able to paint a clear picture of exactly who the actual investors will be, what they'll be looking for as they consider funds, and what they will expect in terms of return.

2. **Uneven Regional Representation:** Although the applicants came from a wide swath of the country, there was a predictable clumping. Lots from coastal cities and urban centers. Few from the deep South or Appalachia. Interestingly, there was a high level of interest from the Southwest.

3. **Real Estate is King:** It was no surprise that most aspiring managers focused on real estate. On one hand, this is not a bad thing – most of the communities in Opportunity Zones need this type of development. However, this was not the fundamental intent of the legislation, which placed high emphasis on financing for operating businesses, venture, and private equity.

4. **Measurement is Murky**: The request for inquiries placed an emphasis on managers articulating how their funds would benefit communities and how they will know whether they've met their mark. Yet the responses contained precious little of this kind of impact analysis and metrics; more often, the managers focused on readily quantifiable outputs, such as units of affordable housing produced, or jobs created.

5. **No Clear Exit:** Managers had few theories about how or when they expect investors to exit funds. This was particularly pronounced for those seeking to invest in small- to medium-sized business. These businesses are chronically illiquid and fund managers were unable to identify scalable solutions to provide an exit to opportunity fund managers.

The Opportunity Fund Incubator

Another significant takeaway from the LOI process was how many emerging fund managers lacked the capacity to even raise a fund. Most of these organizations were strong mission-driven actors steeped in their communities, but which lacked the technical know-how to raise, deploy, and manage a private equity fund. In response, we partnered with Calvert Impact Capital to create the Opportunity Zone Incubator, which provides support and technical advisory services to mission-driven managers seeking to build and launch Qualified Opportunity Funds. Through this partnership, we provided the following services to new Opportunity Fund managers:

1. Identify and build their investment strategy based on the demand in their communities;
2. Determine the feasibility of a mission-driven, marketable Qualified Opportunity Fund;
3. Develop the appropriate fund structure that is responsive to the market demand and fits the requirements of the Opportunity Zone legislation and regulations;
4. Draft the fund's main documents, including a term sheet and offering memorandum;

5. Model the economics of the strategy at the project and fund level to understand the terms and investment profile; and
6. Develop an investor outreach strategy and gather initial feedback from the relevant investor community.

Of the five mission-aligned funds we supported through the Incubator, one is launching its fundraising now and will exit the incubator successfully.

Guarantee Support for Fund Managers

While pleased with the Incubator, we remained concerned that the Opportunity Zone marketplace would be dominated by large, private or institutional fund managers managing hundreds of millions or billions of dollars in capital with no commitment to impact, transparency, or accountability. In the absence of a federal mandate, we acted to incentivize early movers in the space to voluntarily adopt best practices more likely to lead to positive social outcomes.

We partnered with two established private equity fund managers, Community Capital Management and Arctaris to provide a total of $22 million in balance sheet guarantees to their new Opportunity Funds. In exchange, they committed to adopting certain fund-level commitments around transparency, accountability, and impact, all consistent with principles outlined by the U.S. Impact Investing Alliance. We are happy to share those covenants with anyone who is interested; they are posted on our website at Kresge.org. These covenants are largely based on the reporting framework of the New Markets Tax Credit program and are widely accepted by large institutional investors nationally. In addition to serving as a good framework, the collection of these datapoints will also provide Congress and the public with data that can be compared against a dataset generated by a large and well-established program (NMTC) focused largely in the same Census tracts. While by no means conclusive, the ability to compare investments by two Opportunity Fund managers of some scale should provide insight as to how this incentive performs compared to another government program in terms of social impact.

How Opportunity Zones can address the concerns in the Small Business economy

First, it's important to clarify a very common misconception that leads to a flawed understanding of Opportunity Zones. Because the incentive carries many of the hallmarks of traditional community development tools such as the New Markets Tax Credit or the Low-Income Housing Tax Credit, it's tempting to think of it as another government "program." Members of this committee will know it is no such thing. This is a private tax incentive that has created a private marketplace with scant government oversight. There are few restrictions on what this market can invest in, and every investment carries the same innate tax benefits. It is up to the market participants to decide how this market will function. Given that structure, Opportunity Zones certainly can address many of the concerns of the Small Business economy. The more important question is, will the market participants choose to?

To answer that question, it's important to understand the incentives of the three market participants: 1) Investors, 2) Fund Managers, and 3) Business Owners/Developers.

1) For investors, OZ creates a new incentive **to invest capital gains**, in the form of equity, into designated communities for at least five years and with much greater reward for holding for 10 years.
2) For fund managers (in most cases), the typical private equity incentives exist, wherein a fund manager **seeks to maximize investor profit** in the hopes of generating a significant "carried interest" return in the fund.
3) Business Owners/Developers are incentivized to **locate or grow their business** or **significantly improve real estate holdings** in Opportunity Zones and to keep those business holdings for at least five years, with added benefit in holding for 10. In exchange, they seek capital on better terms than what the market would provide (if at all).

Starting from the position of the small business owner in an Opportunity Zone, we can assume they have struggled at some point to access capital to grow their business. Businesses in these census tracts face a chronic barrier to capital. In particular, raising equity for a small business is incredibly challenging, as most small businesses source early equity from "friends and family." For disadvantaged communities and people of color, raising capital from this group of investors is virtually impossible. Opportunity Funds could help incentive new investors to enter this market. However, I remain concerned there is a mismatch between the needs of small business owners and the incentives in place for investors and fund managers. Three primary concerns come to mind.

First, there is the matter of scale. Of the Opportunity Fund managers who have opted to publicly disclose their existence, the vast majority require a minimum investment of $250,000 and are targeting a total raise in the hundreds of millions of dollars. Conversely, if you examine the average size loan for equity substitutes like online lenders or SBA microloans, the vast majority are less than $100,000 per borrower. How you define "small business" is important, but based on the readily available data, I am concerned that most fund managers will seek investments far larger than the capital needs of most small businesses.

Second, there is the issue of liquidity. If we assume an Opportunity Fund manager seeks to invest their fund's capital into a small business in the form of equity, that fund is now a part owner of the small business. The original owner may invest that capital under the agreed upon terms, whether it is to buy new equipment, develop a new product, expand a facility, etc. This could be extremely beneficial to the small business in the short to medium term. However, at the end of the investment period (assume 10 years), if the Opportunity Fund wishes to exit, it's unclear what vehicle would allow that to happen. Hopefully the business has grown substantially — increasing revenues, growing its balance sheet, and hiring more people. At the end of the decade-long period, the business could go to its local bank and seek to take out a loan to pay-off the Opportunity Fund. This is the ideal outcome, but it's not entirely consistent with what we know about small businesses in the U.S. While some businesses start small and grow into large enterprises, the majority remain relatively small. That is due in part to the capital barriers they face. Other businesses do not reach scale because they don't seek to; instead, they fill a niche market, or they are simply out-maneuvered by competition. For these businesses, an equity tool might not be the best solution to their capital challenges and is unlikely to bring real value.

Third, there is the issue of substitution. While investing in small businesses under a venture capital framework (businesses that offer very rapid growth) certainly provides the greatest benefit to Opportunity Zone investors, it also offers the greatest risk. Venture capital is notoriously risky with most investments losing money. Alternatively, real estate, with noted exceptions, has over time provided a very stable long-term rate of return. In addition, because the Opportunity Zone incentive is based on investing in specific geographies, the compliance risk for any investor largely centers around the underlying investment remaining in a designated Census tract for the entire investment period. But operating businesses grow and contract. They hire people, buy new equipment, service customers from multiple states, buy new buildings and merge. From a compliance perspective, real estate investments offer far less compliance risk for an investor at a reasonable return. The Treasury Department has worked to clarify certain regulations that will make it easier to invest in operating businesses. However, real estate will continue to offer a lower risk profile to investors for the foreseeable future. Assuming this, it's unclear why an investor would seek to invest capital in a small business in an Opportunity Zone, absent the rare "unicorn" growth company, when the same tax benefit supports a lower-risk real-estate investment.

Conclusion

There are many excellent organizations working to address the concerns I have brought forward. The U.S. Impact Investing Alliance has proliferated a set of voluntary impact principles for fund managers to adopt. Many CDFIs such as LISC, Enterprise Community Partners, the Community Reinvestment Fund, and Cinnaire are hoping to raise Opportunity Funds focused on both financial return and community impact. There are dozens of for-profit and nonprofit actors trying to approach this work the right way. And of course, for this incentive to be sustainable, investors must make a reasonable return. But the people who live in these places, whose neighborhoods, livelihoods and futures will be most affected by this investment, have every right to expect the very same reasonable social returns in their communities. If Opportunity Zones do not lead to better lives for the people who live in them, then I question the point of this incentive.

This leads me to my final point. It is economic theory bedrock that markets that are not transparent are not efficient. More importantly, they can be dangerous, as we learned from the 2008 financial crisis. We are amid a large-scale social experiment on millions of low-income Americans by highly incentivizing unregulated investments into their communities and prioritizing the appreciation of capital over social impact. Even more concerning is the fact that the members of the American public will never know where OZ capital comes from, where it is being invested, and who benefited from that investment. Without a mandate to disclosure at both the fund and transaction level, it will be impossible to answer those questions.

There will certainly be examples, both positive and negative, of Opportunity Zones addressing the concerns of the small business community. But without data, we can't know which example the norm is, and which is the exception. We need real disclosure and not just attached to the investor tax return where it is not subject to public disclosure.

To fill that gap — not adequately but as well as we can without real reform — Kresge has supported journalists across the country interested in writing about Opportunity Zones. We funded a nonprofit to create a list-serve of now 95 journalists across the country from every medium including television, magazines and newspapers. These journalists are sharing stories, sources and data to piece together what is happening across the country in Opportunity Zones. We plan to expand this work through 2020 and will remain a resource to any and all parties who seek to ensure that Opportunity Zones expand opportunities for people across the country.

Thank you for your time and the opportunity to address this committee.

OPPORTUNITYFINANCE NETWORK™

Testimony of Jennifer A. Vasiloff

Chief External Affairs Officer, Opportunity Finance Network

Provided to the House Small Business Committee's Subcommittee on Economic Growth, Tax and Capital Access

October 17, 2019

Good morning. Thank you for conducting this hearing on Opportunity Zones and the Small Business Economy. My name is Jennifer Vasiloff, and I am the Chief External Affairs Officer of the Opportunity Finance Network (OFN).

Opportunity Finance Network (OFN) is a national network of community development financial institutions (CDFIs). CDFIs are mission-driven community development banks, credit unions, loan funds and venture capital funds investing in opportunities that benefit low-income, low-wealth, and other under-resourced communities across America. CDFIs connect communities to capital that creates jobs, supports small businesses, builds affordable housing, and promotes safe borrowing and lending.

Currently there are more than 1,000 CDFIs certified by the Department of Treasury's Community Development Financial Institutions (CDFI) Fund. Nationwide, the CDFI industry has over $185 billion in assets under management. With cumulative net charge-off rates of less than 1 percent, CDFIs lend prudently and productively in markets often overlooked by conventional financial institutions.

CDFIs are the "boots on the ground" experts in community development finance that have been operating in Opportunity Zones and other disinvested communities for decades. Since the Tax Cuts and Jobs Act of 2017 was signed into law, OFN has been working with our member CDFIs to identify ways for our industry to play a role in Opportunity Zones and to ensure this new source of capital has a positive community benefit. As soon as the Opportunity Zone provision became law, CDFIs across the nation began reaching out to investors, community residents and other partners excited about the potential of this new community development tool.

Many CDFIs devoted significant resources to exploring how to attract Opportunity Zone investors to the projects with high community development impact that CDFIs specialize in. **Regrettably, we have found that the Opportunity Zone tax incentive is not a good match for the kind of neighborhood revitalization deals of interest to CDFIs, particularly those targeting small businesses.** In our experience, most investors are expecting double digit returns, prefer real estate to small business investments and largely shun the more challenging geographies that need an infusion of capital the most.

The structure of the Opportunity Zone incentive may be more suited to investing in a new business locating in a qualifying census tract rather than an existing business. As important as launching a new start-up venture might be, the health and growth of existing businesses is also critically important, particularly businesses that employ community residents.

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Opportunity Fund equity is a difficult fit for many existing small businesses that happen to be located in Opportunity Zones. From the investor side, the structure of the tax incentive and the proposed regulations that have been issued by the Department of the Treasury and the Internal Revenue Service are more conducive to real estate transactions or start-up businesses. A real estate transaction will provide the investor with certainty that their investment cannot relocate outside of the zone. A start-up business will have no issue meeting the original use test, allowing the investor to avoid having to reach the substantial improvement threshold for each asset of a company. From the perspective a small business, it is daunting to give up significant ownership in a business to an unknown investor and substantially improving all of a business' existing assets is unlikely to be a prudent expenditure. Some of these businesses would be better served by an affordable small business loan from a CDFI or other financial services institution - ineligible uses of Opportunity Fund capital.

As a result, relatively few CDFIs are moving forward with establishing their own Opportunity Funds. Among those that are, an even smaller number are planning to concentrate on investment into small businesses. This is reflective of the overall Opportunity Fund market. According to research compiled by Novogradac, only eight percent of the Opportunity Funds they surveyed plan to focus solely on operating business investment.[1]

Two CDFIs that are trying to use the Opportunity Zone incentive for small business investment are Community Reinvestment Fund, headquartered in Minnesota and targeting the upper Midwest for their Opportunity Fund and AltCap, a CDFI serving the Kansas City market. These experienced small business CDFIs are launching Opportunity Funds with the goal of investing in operating businesses. OFN strongly supports their efforts and looks forward to highlighting their work, however both CDFIs have encountered significant obstacles and face competition from Opportunity Funds that are not as mission driven to benefit community residents and local businesses.

Inadequate Data Collection Plan

Separate from the limited role the CDFI industry is likely to play, OFN is concerned that community residents, Congress and other stakeholders will have limited information on how the tax incentive has operated due to the anemic data collection currently planned by the Internal Revenue Service (IRS) and US Treasury. OFN has worked with colleague organizations including those testifying at this hearing to support comprehensive data collection that will show where an Opportunity Zone investment is being made, the results of the investment, and the impact on the targeted community. The data collection by Treasury should be significantly expanded to get the full picture of the impact of investments on communities. This data collection should include the:

- Size of the investment

[1] Novogradc, Michael *"How Much Capital Have Opportunity Fund Managers Raised?"* June 28, 2019, https://www.novoco.com/notes-from-novogradac/how-much-capital-have-opportunity-fund-managers-raised

- Location of the investment
- Type of investment
- Community impacts of the investment
    - Housing units created (affordable and market rate)
    - Permanent, seasonal and construction jobs created
        - Whether those jobs went to residents of the Opportunity Zone
    - Square footage of commercial real estate
    - Number of new small businesses created
    - Other appropriate measures based on asset class (childcare spots created, patients served via a medical facility etc.)

We also recommend that Opportunity Funds provide a brief narrative description of each project investment, which would include: the nature of the project; the benefits to the community; the degree to which the project was developed in consultation with the community residents and/or mitigated against displacement; and the extent to which the project connects with local workforce development efforts for low and moderate income residents. OFN supports the use of an online portal managed by the CDFI Fund for the collection of this data.

In the absence of an adequate federally mandated data collection protocol, OFN contributed to and strongly supports the Opportunity Zones Framework, created in partnership with the US Impact Investing Alliance, the Beeck Center at Georgetown University, and the Federal Reserve Bank of NY, which identifies best practices, a reporting framework, and a shared goal of measuring outcomes. Opportunity Zones and Opportunity Funds require robust data collection in order to accurately evaluate the impact on target communities and to calculate the return on investment from the Federal government.[2] The Kresge Foundation, Urban Institute and Economic Innovation Group were all contributors to the framework.

OFN also supports the bicameral, bipartisan legislation that has been introduced to establish reporting requirements for Opportunity Fund investment. The legislation, HR 2593/S. 1344[3], would require the Secretary of the Treasury to collect data and issue reports on Opportunity Funds and their investments. This legislation is an important first step to bringing much needed transparency to the tax incentive.

Opportunity Zone Designation is Not the Only (or Best) Measure for Community Need

The White House Opportunity and Revitalization Council, established by Executive Order in December of 2018, has been tasked with examining how to target other

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[2] Prioritizing and Achieving Impact in Opportunity Zones, June 2019, https://ozframework.org/about-index

[3] To require the Secretary of the Treasury to collect data and issue a report on the opportunity zone tax incentives enacted by the 2017 tax reform legislation, and for other purposes, HR 2593, 116th Congress (2019)

Federal resources across all agencies toward Opportunity Zones. The Council has already acted to modify 160 programs and grants to give preference to Opportunity Zones.[4] These actions include modifying eight programs at the Small Business Administration, including the Community Advantage Program, the 7(a) Loan Program, and the 504 Loan Program. Beyond the SBA, other programs related to business development have been modified under the Department of Labor, the Economic Development Administration, the Department of Agriculture, among others. Additionally, both the Department of Housing and Urban Development and the Department of Commerce have issued Requests for Information soliciting comments on how they can further target their resources into Opportunity Zones.

It is essential to remember that only a quarter of the eligible census tracts were selected as Opportunity Zones. This means that for every community that could see the benefits of increased private investment through the Opportunity Zone tax incentive, there are three more with similar needs that do not have this new resource available to them. The Federal government must not neglect the communities that were not designated, their businesses, and their residents. When these tracts were selected, Governors did not know that other Federal agencies might target their resources and programs to these same tracts. It is unclear whether this information may have altered some of the designations or informed the strategies used to select and market Opportunity Zones.

Among the census tracts that were selected as Opportunity Zones, we do not currently have the data to indicate which areas are drawing private investment or how private investment is impacting those communities. Modifying the existing landscape of Federal resources in the absence of that data would be premature and potentially detrimental to investors and community stakeholders. It is also unclear what public sector support will be needed in each of the Zones to support private investment and the community. Targeting all Federal resources to Opportunity Zones without proper data collection will make it incredibly difficult to evaluate the success of the tax incentive and determine which community impacts are a result of private investment and which are a result of government action.

With a full data set showing which Opportunity Zones are receiving investment, what types of investment they are seeing, and the impacts on the community of those investments, other Federal agencies can then make an informed decision about how to best tailor programs to support disinvested communities including those designated for Opportunity Zone investments.

Conclusion

In summary, the Opportunity Zone incentive is a poor fit for CDFIs – a missed opportunity to take advantage of the experience, mission commitment and expertise of this nationwide network of community development finance professionals. Unfortunately, new investments in small businesses incentivized by the Opportunity Zone tax benefit are likely to be disappointing also. OFN encourages Members of this

[4] White House Opportunity and Revitalization Council, "*Completed Program Targeting Actions*" October 1, 2019
https://opportunityzones.hud.gov/sites/opportunityzones.hud.gov/files/documents/OppZone_Agency_Completed_Actions_2019_10.01.pdf

Committee to support stronger accountability measures in the Opportunity Zone program and to consider other approaches to foster small business development in underinvested communities including those leveraging the nation's network of community development financial institutions. Included below are several specific recommendations of how the Federal government can support small businesses, particularly in low-wealth communities.

Additional Recommendations for Supporting the Small Business Economy in Low-Wealth Communities

Role of CDFIs in Small Business Lending

The 2017 tax bill creating the opportunity zone tax incentive was a missed opportunity to leverage the expertise and capacity of CDFIs already operating in communities eligible for opportunity zone designation. CDFIs are an important part of the small business lending ecosystem, providing capital to businesses that cannot access traditional financing. As mission-driven lenders, increasing access to affordable, responsible capital for business owners with limited options: women, people of color, start-up firms with limited revenue and less than perfect credit, is a key component of the CDFI lending strategy.

While other lenders have exited the market or charge high interest rates and fees to borrowers, CDFIs have figured out how to lend successfully in the most distressed markets by taking a localized approach to lending, adjusting their strategies and products to meet the needs of their communities, and by being accountable to the communities they serve.

For small business owners with financial impediments to securing financing like lack of collateral, cash flow challenges, modest business revenues, or imperfect credit, CDFIs address these issues in a variety of ways. CDFIs offer a variety of financial products including working capital, equity investments, bridge loans, senior and subordinated debt - sometimes at below market rates with lower and fewer fees. Often CDFIs can employ more flexible underwriting criteria, credit standards, collateralization and debt service requirements than what is otherwise available in the marketplace. While some of the challenges facing small businesses served by CDFIs are financial, others are related to business management practices. The experience of CDFIs has shown that both issues must be addressed for the business to be successful and grow. To that end, CDFIs provide financial education, technical assistance, and capacity-building development services to their borrowers, including business training and access to social and professional networks.

Beyond providing capital and technical assistance, CDFIs serve as an anchor in partnerships with community stakeholders including nonprofits, foundations, chambers of commerce, government agencies, and financial institutions, allowing them to connect entrepreneurs to a rich network of resources and opportunities. Many CDFIs also have referral relationships with local financial institutions, whereby a bank may refer a potential borrower who is not quite ready for conventional financing to a CDFI where the business owner can receive any needed training or technical assistance as well as financing. For many CDFIs, the goal is to help the borrower strengthen and grow their business, improve their financial position, and eventually be able to "graduate" to traditional financing from a mainstream financial institution.

The track record of CDFIs to date is impressive. Through OFN's annual member survey, CDFIs in our network that have reported annual data between 2005-2016 and primarily lend to small businesses (including microenterprises) showed a 200% increase in small business lending from 2005 to 2016, while SBA 7(a) lending increased 58% over the same period. CDFIs are also key financial partners during periods of economic contraction and have demonstrated the ability to increase lending countercyclically.

OFN Member CDFIs exhibited average growth rates in business lending of 7.2% during recessionary years (2007-2009) and 13.2% during post-recessionary years (2010-2016); substantially higher than SBA 7(a) lending where rates averaged -13.6% during 2007-2009 and 17.3% during 2010-2016.[5] In other words, CDFIs increased their small business lending during the recession – and substantially increased lending after the recession – while SBA 7(a) lending, also intended for borrowers that do not qualify for conventional loans, decreased during the recession and shows similar growth rates as CDFIs in the sample following the recession.[6]

Not only did OFN member CDFIs increase business lending during 2007-2009 while SBA 7(a) lending decreased, CDFIs averaged a 4.1% net charge-off ratio compared to 13.9% in the SBA 7(a) portfolio during this period. During post-recessionary years (2010-2016) CDFIs averaged a 2.3% net charge-off ratio compared to 1.2% in the SBA 7(a) portfolio. Over the entire 2005-2016 period, CDFI business lending net charge-off ratios averaged 2.9% compared to 6.5% for SBA 7(a) lending. These trends show that CDFI business lending portfolios offer more stable and better overall performance, avoiding the erratic loss ratios of other business lending portfolios.

CDFI Small Business Lending in Rural and Native Communities

OFN member CDFI lending to businesses has also increased in rural and Native communities: lending in rural areas increased 90% from 2005 to 2016 and lending to businesses in Native areas increased 39% from 2010 to 2016.[7] Even during the financial crisis, while SBA 7(a) lending to rural areas decreased during recessionary years, CDFI business lending to rural areas held steady. CDFI business lending in rural areas shows average growth rates of 0% during 2007-2009 and 14% during 2010-2016 compared to -6% and 14% in the SBA 7(a) portfolio, respectively. Overall, CDFI business lending to rural areas increased 90% from 2005 to 2016 while SBA 7(a) lending increased 63 percent.

In addition to providing financing and technical assistance to individuals and businesses in distressed communities, CDFIs can also be partners in addressing bank closures in rural areas. When Regions Bank was faced with the possibility of closing branches and creating a banking desert in two low-income communities in rural Mississippi, they turned to a CDFI and OFN member Hope Enterprise Corporation/Hope Credit Union. Regions donated the bank branches to Hope, along

[5] Opportunity Finance Network, Database of Annual Member Survey Data, Accessed July 9, 2018.
[6] U.S. Small Business Administration, "Open Data", Released 2018. Accessed July 6, 2018. https://www.sba.gov/about-sba/sba-performance/open-government/foia/frequently-requested-records/sba-7a-504-loan-data-reports .
[7] Lending figures for Native areas are not available prior to 2010.

with a $500,000 technical assistance grant, enabling Hope to reopen and continue to provide access to much needed financial services and credit in those communities.[8]

Federal Support of Small Business Lenders

The Federal government has several existing tools that can increase the supply of capital to mission driven lenders like CDFIs, who are adept at channeling those resources into distressed communities. The subsidy and credit enhancements provided by Federal programs make CDFI business lending financially viable. For lenders, transaction costs are similar whether the loan amount is $10,000, $100,000 or $1,000,000, causing most financial institutions to focus their attention on the higher dollar loans. CDFIs on the other hand, are committed to meeting the credit needs of their borrowers, who seek smaller loans and have nontraditional financing needs.

Existing Federal programs are complementary resources that work together, allowing CDFIs to offer a variety of financing tools to meet the needs of businesses seeking financing, whether it is a $500 microloan to a new entrepreneur, $100,000 to help a business grow, or multimillion-dollar financing for larger businesses to purchase equipment or real estate. CDFIs are key partners for underserved businesses along the spectrum.

The following are recommendations that will preserve and expand key Federal programs that increase the availability of capital for small businesses:

- **Full funding for the Department of Treasury's CDFI Fund's Financial Assistance and Technical Assistance program** to allow certified CDFIs access to flexible, patient capital needed to provide financing to underserved businesses, and to provide critical technical assistance and development services to help small businesses grow and thrive. The CDFI Fund programs have helped CDFIs deepen their reach into highly distressed communities. The Department of Treasury's CDFI Certification criteria requires CDFIs to originate at least 60% of loans and investments in eligible distressed census tracts or to underserved populations, and CDFIs continue to exceed that target. In FY 2018, the CDFI Program surpassed the 60.0 percent threshold for the percentage of both the dollar amount (73.7 percent) and the number of CDFI loans (72.1 percent) made to eligible distressed communities and underserved populations..[9] Further, in the FY 2017 award round, 29% of award recipients primarily served rural markets, well above the 14% of Americans currently residing in rural areas.

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[8] "Hope Credit Union to Expand Presence in the Mississippi Delta", June 25th, 2015. Accessed July 9, 2018. https://hopecu.org/2015/06/hopeforthedeltarelease/

[9] U.S. Department of the Treasury, "Community Development Financial Institutions Fund Congressional Budget Justification and Annual Performance Report and Plan FY 2020", March 2019. Accessed October 16, 2019 https://home.treasury.gov/system/files/266/11.-CDFI-FY-2020-CJ.pdf

While these results are impressive, additional resources for the CDFI Fund will further stimulate financing to small businesses in rural and Native communities. The CDFI Fund programs are highly oversubscribed: applicants on average have requested more than four times the available amount of funding each year. In the FY 2019 application round, the CDFI Fund received 546 requesting more than $579 million. In the CDFI Program alone, 499 organizations requested $373.28 million in CDFI Program Financial Assistance (FA) and Technical Assistance (TA) awards, while the CDFI Fund has only $160 million in funding to award in FY 2019.[10]

The Native CDFI Assistance (NACA) Program has catalyzed dramatic growth in lending to Native communities. Native CDFIs seen their assets grow fivefold since 2001, in large part due to the CDFI Fund, which has provided over $93 million in capital, training and technical assistance to Native CDFIs.[11] The NACA program is similarly oversubscribed: in FY 2019, 53 organizations requested more than $29 million in NACA Program FA and TA awards, significantly more than the $16 million available in appropriated funds.

- **Full funding for the Department of Agriculture's Rural Development Small Business Lending programs:**
    - *Intermediary Relending Program (IRP)* provides local intermediaries, such as CDFIs, access to low-cost, long-term flexible capital up to 30 years to address challenges in rural communities. CDFIs then relend this money to businesses and economic development projects which create jobs in rural communities.
    - *Business and Industry Loan Guarantee Program* is a loan guarantee program designed to *assist* help credit-worthy rural businesses obtain needed credit.
    - *Rural Microentrepreneur Assistance Program (RMAP)* provides loans and grants to non-profit organizations, like CDFIs, which provide technical assistance and microloans to rural small business owners.
    - *Rural Business Development Grants (RBDG)* are competitive grants that support targeted technical assistance, training and other activities leading to the development or expansion of small and emerging private businesses in rural areas that have fewer than 50 employees and less than $1 million in gross revenues.
    - *Value-Added Producer Grants (VAPG)* - The Value-Added Producer Grant (VAPG) program is a competitive grant program administered by

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[10] U.S. Department of the Treasury, CDFI Fund Releases Application Demand for FY 2019 Round of CDFI Program and NACA Program", September 3, 2019. Accessed October 16, 2019 https://www.cdfifund.gov/news-events/Pages/news-detail.aspx?NewsID=353&Category=Updates

[11] Derrick Rhayn, "In Indian Country, Native CDFIs Work to Restore Food Sovereignty", Nonprofit Quarterly, April 17, 2018. Accessed July 9, 2018. https://nonprofitquarterly.org/2018/04/17/indian-country-native-cdfis-work-restore-food-sovereignty/

the Rural Business-Cooperative Service of USDA that provides funding to independent agricultural producers, groups of independent producers, producer-controlled entities, organizations representing agricultural producers, and farmer or rancher cooperatives to create or develop value-added producer-owned businesses. These grants may be used to fund business and marketing plans and feasibility studies or to acquire working capital to operate a value-added business venture or alliance.

- **Make permanent the Small Business Administration's Community Advantage program** for mission driven lenders which is set to sunset September 30, 2022 and raise the maximum loan amount to $350,000. The Community Advantage program is currently a pilot program under the SBA's popular 7(a) program to meet the credit, management, and technical assistance needs of small businesses in underserved markets. Community Advantage provides mission-based lenders access to 7(a) loan guaranties as high as 85% for loans up to $250,000. Since the program's inception, Community Advantage lenders have approved more than 5,800 loans for small businesses totaling over $777million, and of the 99 active Community Advantage lenders, a large majority are certified CDFIs, helping the program reach businesses in underserved markets.[12]

  With an average loan size of $129,108, and a requirement that at least 60% of the number of loans made under program go to underserved communities, Community Advantage allows lenders to make those smaller loans of $50,000 to $250,000 that are often difficult for business owners to access. Lenders are also able to sell the guaranteed portion of the loan on the secondary market, generating unrestricted, earned income that can help mission-driven lenders finance even more small business lending.

  This program meets a pressing unmet financing need for businesses poised for growth out of the microloan program but that might not be ready for traditional bank financing, but lenders need the certainty that a permanent Community Advantage program would provide.

- **Expand the Small Business Administration's Microloan** Program and provide additional technical assistance funds. The Microloan program is an important source of capital for microlenders to make loans up to $50,000 to women, low income, veteran, and minority entrepreneurs, and other qualified small businesses. Under the Microloan Program, SBA makes direct loans to intermediaries that use the proceeds to make small loans to eligible businesses and provides grants to intermediaries and other qualified non-lending technical assistance providers to assist borrowers with marketing, management, and other business based training and technical assistance. Demand for the financing provided through the Microloan program has been increasing steadily: the number of businesses assisted by the program has

[12] Congressional Research Service, Small Business Administration 7(a) Loan Guaranty Program, Updated October 15, 2019, https://fas.org/sgp/crs/misc/R41146.pdf.

increased by more than 12% since FY2013, and the number of jobs supported by microloans has increased by more than 31 percent.[13]

- **Reauthorize of the recently expired State Small Business Credit Initiative (SSBCI),** a program created through the Small Business Jobs Act of 2010 to increase access to capital for small businesses by providing credit enhancements for small business lending, with a focus on reaching underserved communities. CDFIs made nearly 11,000 loans or investments supported by SSBCI funds, totaling $835 million in new financing through 2016. A new round of funding could further stimulate small business development.
- **Strengthen strong small business borrower protections** that ensure business owners have access to information about the types of business loan products offered so business owners can make informed decisions. Small business borrowers deserve better information, clear disclosure, and understanding of financial resources and agreements. There are substantial disclosure requirements in the mortgage lending and consumer lending arenas, but no such protections or requirements exist for small business borrowers.
- **Support better research and data on access to capital issues in rural and Native markets** – There is limited comprehensive information available focused on analyzing the specific needs and challenges facing businesses in rural and Native markets. Congress should provide funding to study the specific challenges in these markets to identify targeted solutions that meet community needs.

Conclusion

CDFIs are critical intermediaries that deliver capital to businesses and communities that need it most, building credit and financial infrastructure that provides the financing needed to improve their economic well-being. At their core, CDFIs are about partnership, innovation, and creating opportunity in those communities that are often forgotten. But the work of CDFIs is not done alone: partners like the Federal government remain vital to continuing the powerful work of mission driven lenders like CDFIs. CDFIs are also a smart investment for the Federal government: small amounts of public subsidy are leveraged to amplify its impact. For example, the CDFI Fund has reported that for every dollar it awards to a CDFI, the CDFI leverages twelve dollars from non-Federal sources.

Additional investments in proven solutions and programs like those that support the work of CDFIs will stimulate the flow of capital to business owners, generating economic activity that can create jobs, catalyze community development and generate income and wealth.

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[13] U.S. Small Business Administration, FY 2020 Congressional Justification FY 2018 Annual Performance Report, https://www.sba.gov/sites/default/files/2019-04/SBA%20FY%202020%20Congressional%20Justification_final%20508%20%204%2023%202019.pdf.

TESTIMONY BEFORE THE HOUSE COMMITTEE ON SMALL BUSINESS
SUBCOMMITTEE ON ECONOMIC GROWTH, TAX, and CAPITAL ACCESS

JOHN W. LETTIERI
PRESIDENT & CHIEF EXECUTIVE OFFICER
ECONOMIC INNOVATION GROUP

"CAN OPPORTUNITY ZONES ADDRESS CONCERNS IN THE SMALL BUSINESS ECONOMY?"

October 17, 2019

Introduction[1]

Chairman Kim, Ranking Member Hern, and members of the Committee: Thank you for inviting me to testify regarding how the Opportunity Zones tax benefit can be used to support new and growing businesses in struggling communities.

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 focused on the decline of economic dynamism and the growing divides between thriving and struggling American communities.

EIG was a leading proponent of the concept behind Opportunity Zones, and I believe the policy as enacted can provide a new lifeline of much-needed investment to struggling communities nationwide if implemented properly. While the incentive was designed to support a wide variety of needs across communities – from housing, to clean energy, to commercial development – its central purpose[2] was to support new businesses and existing small and medium-sized firms in need of growth capital. My testimony today will focus on the policy, regulatory, and practical steps still necessary to achieving this goal.

The Structure and Goals of Opportunity Zones

While there have been a number of previous federal incentive programs aimed at boosting economic activity in underserved areas, the Opportunity Zones incentive is a sharp departure from past precedent in its scope, flexibility, and structure. Perhaps for this reason, it has generated enormous interest among local leaders, investors, philanthropic organizations, and economic development practitioners. Unlike most other federal programs, this incentive can be

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[1] Much of this testimony is taken from the following testimonies:
John Lettieri, "Testimony for Senate Committee on Small Business and Entrepreneurship Hearing on Small Business and the American Worker," March 6, 2019
John Lettieri, "Testimony for Senate Committee on Small Business and Entrepreneurship Hearing on Expanding Opportunities for Small Businesses Through the Tax Code," October 3, 2018
John Lettieri, "Testimony for Joint Economic Committee Hearing on the Promise of Opportunity Zones," May 17, 2018
[2] Bipartisan, Bicameral Congressional Letter to Treasury on Opportunity Zones, January 23, 2019
Press Release, Senator Scott Introduces the Bipartisan *Investing in Opportunity Act*, February 2, 2017

used in a variety of ways, making it a potentially important and creative tool for financing a range of economic priorities across many different types of communities. At its core, the policy is intended to support the creation of new economic value within communities, either by establishing something new, such as an operating business or commercial development, or by making large-scale improvements to existing businesses or assets within a community.

The Opportunity Zones incentive provides a series of benefits to taxpayers that reinvest their capital gains into qualifying investments in designated low-income communities. The incentive is designed to reward patient capital, with the most significant benefit kicking in only after 10 years. The communities themselves were selected by governors in each state based upon federal income and poverty criteria. Governors were allowed to designate up to 25 percent of the eligible census tracts as Opportunity Zones, which in turn makes certain investments in those areas eligible for a federal tax benefit. To be eligible, an investment must be made using equity capital and deployed through a "Qualified Opportunity Fund," which is any investment vehicle specifically organized to make qualifying investments in Opportunity Zones communities per the statute.

As a group, the designated communities have far higher levels of socioeconomic need than required by statute. They are also needier in terms of poverty rates, median family incomes, educational attainment, and a host of other criteria than the cohort of eligible tracts governors did not select. While the need-targeting was in general strong, a small percentage of designations have drawn justifiable criticism for being undeserving of Opportunity Zone status, despite being technically eligible according to U.S. Department of the Treasury standards. Such concerns should inform future legislative efforts to expand or improve the policy.

How the average Opportunity Zone census tract compares to other peer groups

	Poverty Rate	Median Family Income	Minority Share	Adults w/o a high school diploma	Adults w/ a bachelors degree or higher	Prime age adults not working	Housing vacancy rate	Life expectancy
Opportunity Zones	28.9%	$44,700	56.3%	21.8%	17.5%	36.4%	12.8%	75.1
Non-OZ low income census tracts	24.0%	$49,700	52.5%	20.0%	19.6%	32.7%	11.0%	76.2
All low-income census tracts	25.3%	$48,300	53.6%	20.5%	19.0%	33.7%	11.5%	75.9
United States	14.6%	$70,900	38.5%	12.7%	30.9%	27.0%	8.2%	78.3

The State of American Entrepreneurship

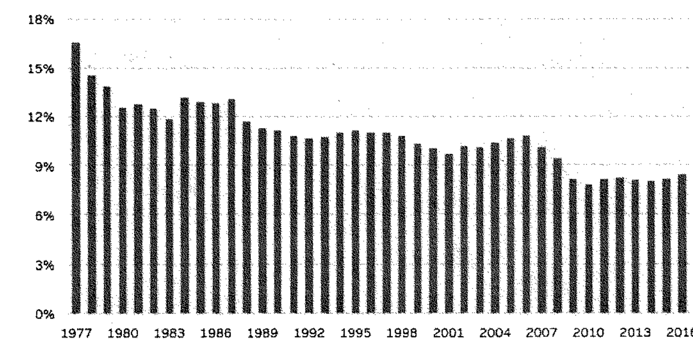
Before going any further, I want to briefly examine the state of American entrepreneurship and how it relates to the Opportunity Zones initiative.

Policymakers generally devote too much attention to *small* businesses and not nearly enough to *new* businesses. One often hears that small businesses are the backbone of U.S. job creation, but it is specifically the small cohort of *new* businesses that grow and add employees to which most net new job creation can be attributed each year. EIG's research finds that new business formation was abysmal in the wake of the Great Recession, both in terms of the rate and scale of new firms, as well as the geographic distribution of net firm formation. Yet this decline in entrepreneurship started long ago and is the centerpiece of an economy-wide decline in dynamism that defies popular notions of the current era being one of unprecedented economic change and disruption.

Over the past several decades, the startup rate, defined as the percent of all firms in the economy that started in the past year, has declined across virtually all regions and sectors of the economy. It fell steadily through the 1980s and 1990s before collapsing with the Great Recession. Troublingly, the national economic recovery has done little to improve the rate of business formation. Startup activity finally picked up in 2016, as the rate of new business creation improved to 8.4 percent. Yet even that post-recession high left the startup rate 2 percentage points below its long-run average, which translates to roughly 100,000 "missing" new companies annually.

Startup rate

Share of new firms as a % of total firms



Source: U.S. Census Bureau Business Dynamics Statistics

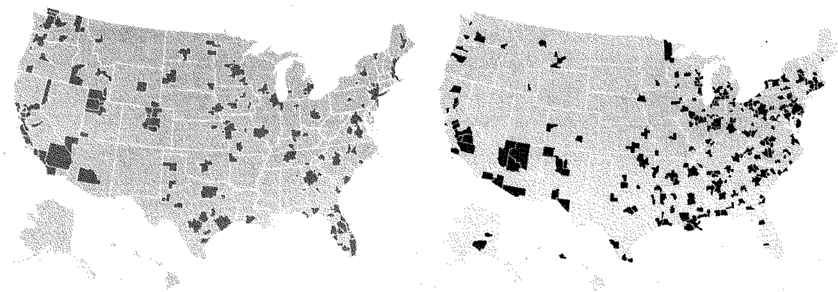
The latest business application data from the Census Bureau tell us that as recently as the 2nd quarter of 2019, there were 17 percent fewer promising new businesses in the queue than in 2006.[3] The latest figures on actual startups show no real rebound at all between 2010 and 2016, making entrepreneurship one of the few indicators that have failed to meaningfully improve in spite of an ongoing economic expansion. Consider that between 2006 and 2019 real U.S. GDP grew by nearly $4 trillion and our population increased by nearly 30 million, and it becomes clear that the U.S. economy is growing relatively less entrepreneurial every year.

The decline in business dynamism has significant implications for the health of regions and communities. For the three decades prior to 2007, the vast majority of U.S. metro areas saw net increases in local firms each year. This changed dramatically with the Great Recession. Metro-level data from the latest year available, 2014, revealed that 61 percent of U.S. metro areas *lost* firms that year, meaning too few startups were launched to replace businesses that closed. The

[3] U.S. Census Bureau Business Formation Statistics, High-Propensity Business Applications

trend shows that across much of the country the cycles of churn and creative destruction that keep the economy healthy are breaking down.

Metro areas with increasing (left) and decreasing (right) numbers of firms in 2014



142 metro areas saw a **rise** in firms in 2014 **224** metro areas saw a **decline** in firms in 2014

Source: EIG's "Dynamism in Retreat" and U.S. Census Bureau Business Dynamics Statistics

The slowdown in entrepreneurial activity is even more pronounced in economically struggling communities. EIG's Distressed Communities Index finds that the typical distressed zip code lost 5 percent of its business establishments from 2012 to 2016. On current trendlines, the same group of zip codes, representing one-fifth of all zip codes in the United States, will never recover the 1.3 million jobs they lost to the Great Recession. While numerous overlapping and complicated forces contribute to these outcomes, it is no coincidence that more entrepreneurial eras in American history were also times of more broadly shared prosperity.

Demographics stand out as a growing headwind for the U.S. economy with significant implications for the future of American entrepreneurship. The United States once enjoyed some of the highest rates of population growth in the developed world. Today, the rate of U.S. population growth stands at its lowest level since the Great Depression and half the level of the early 1990s. Economists have made considerable advances in the past two years explaining how this new development will impact the dynamism of the U.S. economy.

We reviewed the literature on demography and dynamism in a recent report.[4] Two prominent studies demonstrate how the slowing growth and aging of the population leads to fewer new firm starts.[5] An analysis of Moody's Analytics data found that a 1 percentage point decline in population growth from 2007 to 2017 caused a county's startup rate to decline by 2-3 percentage points.[6] Another shows how the aging of the large baby boom generation may be contributing to multiple related phenomena: fewer firm starts, an aging firm distribution, a growing

[4] Adam Ozimek, Kenan Fikri, and John Lettieri, "From Managing Decline to Building the Future: Could a Heartland Visa Help Struggling Regions?" Economic Innovation Group (2019).
[5] Fatih Karahan, Benjamin Pugsley, and Aysegul Sahin, "Demographic Origins of the Startup Deficit." Technical Report. New York Fed, mimeo, 2016 and Manual Adelino, Song Ma, and David Robinson. "Firm age, investment opportunities, and job creation." *The Journal of Finance* 72.3 (2017): 999-1038.
[6] Ozimek, et al., "From Managing Decline."

concentration of employment into larger firms, and a falling share of national income going to workers.[7] Demographic stagnation and population loss are especially serious concerns for a large share of Opportunity Zones communities, 45 percent of which have lost population over the past decade.[8]

Another challenge faced by Opportunity Zones communities, like many other low-income communities, is capital access. Capital access is an especially critical piece of the puzzle for early stage entrepreneurs, and it is noticeably weak in most Opportunity Zones communities. Entrepreneurs often forgo traditional forms of capital such as bank loans and equity investments, relying instead on personal or familial savings to cover initial startup costs. With an average poverty rate nearly double the national average, Opportunity Zones entrepreneurs are less likely to have access to expendable savings. If they turn to traditional forms of financing, they may run into roadblocks there as well. Not only has small business lending remained frozen since the Great Recession in real terms, but 43 percent of all community banks have disappeared since 2000. There are no commercial banks in nearly half of all Opportunity Zones, and only 4 percent of the total dollar volume of CRA-oriented small business loans under $100,000 occur within Opportunity Zones.[9] Furthermore, it is well documented that the geography of startup financing is very narrow, with roughly 75 percent of venture capital going to just three states each year: New York, California, and Massachusetts.

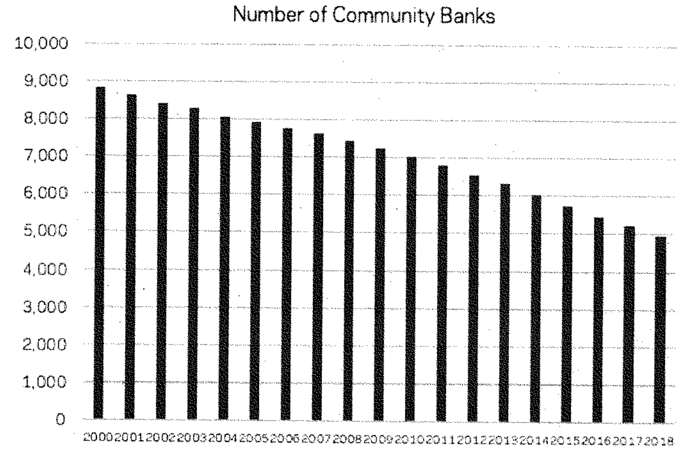
Real Total Small Business Lending, Millions

Source: FDIC

[7] Hugo Hopenhayn, Julian Neira, and Rish Singhania, From Population Growth to Firm Demographics: Implications for Concentration, Entrepreneurship and the Labor Share." No. w25382. National Bureau of Economic Research, 2018.

[8] See EIG's "Opportunity Zones Facts and Figures"

[9] EIG Analysis of Community Reinvestment Act data



Source: FDIC Call Reports

Opportunity Zones could help fill an important financing gap by incenting equity investment in places that have largely struggled to access entrepreneurial growth capital, allowing entrepreneurs to stay and build economic opportunity and wealth for their communities. However, it is important to note that equity capital, while vitally important for the kind of growth-oriented companies that create significant jobs and value in a community, is not the right source of financing for most businesses. The Opportunity Zones is therefore not a panacea for meeting the capital needs of all types of businesses.

Early Opportunity Zones Market Activity

While the Opportunity Zones market is still nascent, most of the early investment has gone into an array of real estate developments. This is due to a number of factors, including the fact that improvements to the built environment is often a crucial first step in bringing people and businesses back into a community. One less benign factor is the continued lack of regulatory clarity governing investments in operating businesses, which I will address later in my testimony.

Even though the marketplace is far from fully formed, the Opportunity Zones incentive is being used to support a wide range of investments across the country just as Congress intended. Investments in clean energy, broadband infrastructure, vertical farming, manufacturing, and industrial facilities are a sign of the long-term potential of the incentive, even if the scale of capital flowing to such investments remains limited. Many early investments are going into basic neighborhood amenities, such as grocery stores in food deserts, medical clinics, and new housing of all different types. Small cities are using Opportunity Zones as a catalyst to build or expand local innovation districts or revitalize blighted downtown corridors. Anchor employers, from

Fortune 500 companies to major hospital systems, are helping to jumpstart investment in communities like Cleveland, OH, and Erie, PA.

Several early investments are using real estate development to support a stronger local startup ecosystem. For example, Launch Pad, a network of coworking spaces that started in New Orleans, is planning to expand into Opportunity Zones in more than 20 markets over the next year. The company also plans to start an Opportunity Fund to invest in the businesses that occupy their space. In South Los Angeles, SoLa Impact, an affordable housing developer, saw the chance to unlock the entrepreneurial potential of its surrounding community, and is now using Opportunity Zones capital to build "The Beehive," a five-acre business campus and co-working space in a largely vacant industrial corridor.

Examples like these will proliferate as the rules and best practices for Opportunity Zones become more widely understood among communities, investors, and local businesses. While there are many encouraging signs of activity, I would caution against drawing broad conclusions from anecdotes at such an early stage. Without additional regulatory clarity and much stronger local implementation efforts, this policy will not reach its full potential.

Regulatory Hurdles Limiting Opportunity Zones Financing for Local Businesses

The rulemaking process is now in its final stages, but regulatory concerns are keeping many investors who wish to deploy capital into operating businesses on the sidelines. Specifically, the following technical issues[10] must be addressed in the final regulations in order to avoid repeating the shortcomings of previous federal efforts to support the growth of local businesses in low-income communities:

- Substantial Improvement Test: The "substantial improvement" test is a central feature of the Opportunity Zones legislation, requiring investments in existing businesses or assets to demonstrate significant new economic value creation. However, the draft regulations currently require the substantial improvement test to be assessed on an asset-by-asset – rather than aggregate – basis. This approach is extremely impractical and will hinder the ability for businesses to qualify for Opportunity Zones investment.
- Timing Considerations: Opportunity Funds need adequate time to build a portfolio of qualifying business investments. However, the draft regulations currently provide a window as short as six months for an Opportunity Fund to deploy any capital it receives from its investors. EIG and other commenters have recommended a minimum of one year, which is the same time period allowed under the New Markets Tax Credit.
- Recycling Capital from "Interim Gains": Congress intended Opportunity Funds to have the ability to operate as true portfolio funds, allowing investors to mitigate risk by pooling capital together and deploying it in a variety of investments. Furthermore, Congress anticipated that an Opportunity Fund 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 is critical for Funds that intend to invest in operating businesses,

[10] Several of these recommendations can be found in the EIG Opportunity Zones Coalition's public comment letter (July 1, 2019)

which are inherently less predictable than real estate projects. However, the current proposed regulations would treat the sale of a business held by an Opportunity Fund as a taxable event for the Fund's investors even if the proceeds are fully reinvested back into a new qualifying investment. In practice, this means that the sale of an asset held by an Opportunity Fund and the reinvestment of the proceeds back into a designated low-income area could result in a large tax bill for investors who have not yet received a distribution from the fund. This disharmony between the intent of the statute and current rulemaking undermines the utility of the incentive to support local operating businesses.

Unless we sufficiently address these and other key issues, it will be difficult for Opportunity Zones to live up to their full potential to boost investment in local businesses and create new economic opportunities for residents of distressed communities. Instead, it may go the way of previous federal policies that have a generally poor track record of encouraging private investment in businesses, and especially into new firms.

Other Tools are Needed

Opportunity Zones are designed to work alongside existing policy tools to support local businesses and entrepreneurial ecosystems across the country. But the current policy toolkit is woefully inadequate compared to the scale of the challenges.

To that end, I offer the following recommendations.

- Legislative improvements to Opportunity Zones. There are a number of potential legislative changes that Congress may want to consider, ranging from technical corrections to more significant improvements that would enhance the incentive's benefits to designated communities. But perhaps the most obvious is to enact clear and practical reporting requirements that will help ensure the policy's impact can be properly evaluated over time. EIG has worked closely with a bipartisan group of lawmakers in the House and Senate on such transparency legislation,[11] and we urge Congress to pass this uncontroversial measure as quickly as possible.
- Technical assistance to Opportunity Zones communities and stakeholders. Communities and local stakeholders need help navigating the use of the Opportunity Zones incentive and developing local implementation strategies. Federal agencies, especially the Small Business Administration (SBA), should be leading such efforts. The SBA should provide much-needed technical assistance to both Opportunity Funds and Opportunity Zone businesses on eligibility requirements, best practices, and other issues to ensure they are equipped to take advantage of the incentive as intended.
- Create new pathways for skilled immigrants to locate in struggling communities. In light of what we now know about the close ties between demographics, population growth, and startup rates, as well as the high propensity of immigrants to become inventors and entrepreneurs, we should recommit to comprehensive reform to our broken immigration system. My view is that a cornerstone of any such package must be a place-based visa – what EIG calls a "Heartland Visa" – that would allow places confronting demographic

[11] H.R.2593 - To require the Secretary of the Treasury to collect data and issue a report on the opportunity zone tax incentives enacted by the 2017 tax reform legislation, and for other purposes.

decline to welcome new skilled immigrants to their communities through a new program designed for community renewal. Such a program would need to be additive to national top-line skilled immigration flows; it could not repurpose existing visas and still achieve the same economic impact. The idea has been endorsed by business leaders and the U.S. Conference of Mayors.

- Limit the use of non-compete agreements. A growing body of research points to one simple way to boost wages, strengthen innovation, enhance competition, and spur greater levels of entrepreneurship – all without enacting any new programs or increasing federal spending: restrict the use of non-compete agreements in all but the narrowest of circumstances. Non-competes reinforce the advantages of incumbency for existing employers, protecting them from competition at the expense of workers and entrepreneurs. Any serious discussion about creating a more vibrant and competitive economy must include non-competes reform.
- Reform the Small Business Administration. The Small Business Administration plays a critical role in providing technical assistance, financing, and resources to small businesses and established industries, but the agency should modernize its policies to better serve entrepreneurs and new startups entering the market. The SBA should focus on high-growth technology and manufacturing companies, and develop better tools to boost American innovation. EIG joined a letter penned by innovation experts in July in support of such modernization proposals.
- Reauthorize the State Small Business Credit Initiative: The State Small Business Credit Initiative (SSBCI) was a component of the Small Business Jobs Act of 2010 that generated high-impact entrepreneurial activity and investment ecosystems in all different parts of the country. The innately decentralized program built capacity in every state by providing $1.5 billion in flexible financing to intermediaries that disbursed it to entrepreneurs throughout the country, nearly one-third of whom built their companies in low- and moderate-income census tracts like Opportunity Zones. The initiative lapsed in 2017; Congress should reauthorize it or establish a successor.

What I have outlined here are just some of the building blocks of a comprehensive policy toolkit to support American entrepreneurs, restore U.S. economic dynamism, revitalize our communities, and ultimately restore the promise of the American Dream. Non-competes reform would unshackle potential entrepreneurs and tip the scales back in favor of workers and startups, away from incumbent vested interests. SBA reform and a restoration of the SSBCI would modernize federal approaches to supporting our entrepreneurs and business owners and building local capacity with public dollars. Improving Opportunity Zones and empowering communities to strategically deploy the incentive would further unlock private capital and help achieve national scale. And place-based visas would boost the dynamism and economic stability of struggling areas. No single policy, no matter how well-designed, will be sufficient. A coordinated onslaught, however, could make a real difference.

Conclusion

Opportunity Zones is a promising new initiative that will require much additional work to achieve its intended purpose. Rulemaking is not yet complete. Community stakeholders are still finding their footing. The philanthropic community, which could be playing a crucial role in shaping the early market, has been slow to engage at meaningful scale. And investors remain hesitant to make long-term investments in areas they might not have previously considered. That this is hard work should come as no surprise. As a country, we have largely neglected the underlying challenge this policy is designed to help address, allowing thousands of communities and millions of our fellow citizens to deal with the consequences of disinvestment and decline even in the midst of national growth and prosperity. There will be no overnight success stories, but with the right tools and a much greater commitment of resources, I believe Opportunity Zones can be an important first step in a new movement of place-based policymaking.

Thank you and I look forward to taking your questions.

SBIA
SMALL BUSINESS
INVESTOR ALLIANCE

October 21, 2019

VIA ELECTRONIC TRANSMISSION

The Honorable Nydia M. Velazquez, Chair
House Small Business Committee
2361 Rayburn House Office Building
Washington, D.C. 20515

The Honorable Steve Chabot, Ranking Member
House Small Business Committee
2361 Rayburn House Office Building
Washington, D.C. 20515

The Honorable Andy Kim, Chair
Subcommittee on Economic Growth, Tax and Capital Access
U.S. House Small Business Committee
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The Honorable Kevin Hern, Ranking Member
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2361 Rayburn House Office Building
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RE: Opportunity Zone Program Hearing Record Submission

Dear Chair Velazquez, Ranking Member Chabot, Subcommittee Chair Kim and Subcommittee Ranking Member Hern:

On behalf of its membership, the Small Business Investor Alliance ("SBIA") is pleased to submit these comments for the record in the hearing on October 17, 2019, by the Subcommittee on Economic Growth, Tax and Capital Access entitled, "Can Opportunity Zones Address Concerns in the Small Business Economy?".

The SBIA is the national organization that represents small business private equity funds and their investors, including Small Business Investment Companies ("SBICs") and banks that invest in them.

The SBIA commends Congress and the Administration for their successful bipartisan collaboration that brought the Opportunity Zone program into existence in 2017. The statutory purpose underpinning the program is to encourage sustained economic growth and investment in designated distressed communities ("Opportunity Zones" or "OZs") by providing federal tax benefits to taxpayers who invest new capital in businesses ("qualified opportunity zone business" or "QOZB") located within those OZs through a Qualified Opportunity Fund ("QOF").[1]

SBIA's members are a natural constituency for the OZ program because they are privately-owned and managed investment funds that invest exclusively in domestic small businesses. Market uptake among this group in the OZ program during its initial years of operation, however, has not been as robust compared to QOFs formed for real estate investments. SBIA believes this is more likely a function of the program's regulatory structure and the operational focus of QOFs with investment strategies that lean heavily towards real estate opportunities.

Rather than crafting complex and targeted recommendations to amend the regulatory structure for QOFs, SBIA instead offers a straight-forward suggestion: leverage the U.S. Small Business Administration's (SBA) long-standing SBIC program, created explicitly for small business investing and job creation, to

[1] 26 U.S.C. 1400Z-2 (2017). SBIA's membership are also mindful that time is of the essence when it comes to investing in QOFs because investments must be made on or before December 31, 2019, to ensure maximum tax benefits under the OZ program because its authorization expires in 2026.

complement QOFs and deliver on the legislative purpose for the OZ program to infuse capital investment in small businesses located in underserved areas.

A recent independent study prepared for the Library of Congress found that SBIC-backed small businesses created almost three million new jobs and supported an additional 6.5 million jobs over the 20-year period of their study.[2] Every one of those jobs created by each of those small businesses was a gain to the communities where they are located and to the broader regions from where they drew employees and to whom they provided goods and services. Additionally, the SBIC program receives an annual $4 billion authorization but rather than maximize zero-subsidy loans to domestic small businesses, the SBA does not deploy this capital fully to SBICs, which leaves money on the table that could be stoking small business growth and fostering job creation.

If the goal of Opportunity Zones is to bring prosperity and economic opportunity to parts of America that lack both, then there is no better example of the type of investments that the QOFs seek to make than the mission-driven, job-creating small business investments made by SBIC funds.

Since its inception more than 60 years ago, the SBIC program has included various classes of SBICs including early-stage, energy, impact investment and low-and moderate income ("LMI"). An LMI Zone is a low and moderate-income geographic area that meets one of several federal definitions for targeted underserved areas because of economic or employment challenges. By the end of the third quarter of FY19, approximately 21 percent of SBIC investments were in small businesses located in LMI areas.[3]

SBIA recommends that Congress direct the SBA to amend its existing regulations and designate Opportunity Zones within the definition of an "LMI Zone" eligible for SBICs to make investments of debt and equity capital.[4] Upon such designation, interested fund managers including current SBIC licensees could structure investment strategies and begin the licensing process to stand up this new class: Opportunity SBICs ("OSBICs"). This also aligns the current implementation plan of the White House Opportunity and Revitalization Council for the integration of OZs "into existing federal programs".[5]

By taking this step, Congress enables the OZ initiative to expand capital access more rapidly to QOZBs by leveraging the proven infrastructure of an existing federal program to evaluate, qualify, and monitor OSBICs and their investment strategies.

Thank you for the opportunity to present these comments. SBIA looks forward to continued collaboration with the House Small Business Committee to ensure that America's small businesses and the communities served have access to the capital they need.

Sincerely,

Brett Palmer

Brett Palmer
President
Small Business Investor Alliance

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[2] Paglia and Robinson, Measuring the Role of the SBIC Program in Small Business Job Creation, Report for the Library of Congress, at 4 (January 2017) <https://www.sba.gov/sites/default/files/articles/SBA_SBIC_Jobs_Report.pdf>.
[3] SBIC Program Overview at 2, U.S. Small Business Administration (June 30, 2019). (The percentage share jumps to 25 percent when including SBIC investments in women, minority, or veteran-owned small businesses.)
[4] 13 C.F.R. 107.50
[5] Implementation Plan for the White House Opportunity and Revitalization Council at 11 (April 2019).