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In the Zone.

A new federal program may be a boon to distressed cities – if it targets the right ones.

York, Pa., grew up making things. The brick smokestacks that break up the skyline are inescapable reminders of its industrial past. Buildings that once housed factories employing hundreds of workers have now been converted into warehouses that employ only a handful of people, at wages that don't come close to rivaling those of their industrial predecessors.

Mayor Michael Helfrich grew up in York. He remembers when middle-class jobs were only a short walk away from the homes of the men and women who produced everything from Pullman cars to Pfaltzgraff dinner plates to York Peppermint Patties. Those companies are gone. Pullman succumbed to competition from Detroit automakers. Hershey's bought the York candy factory and moved production to its own plants, which eventually landed in Mexico in 2009. Pfaltzgraff was purchased in 2005 and its operations moved to China.

But most of the jobs haven't left because of competition or consolidation as much as they've left to escape York's taxes, which are almost three times the rate in surrounding York County. The taxes have led to a vicious cycle — innovation, development and flight — that has persisted for decades. "We used to build wealth in the city of York," Helfrich says. "In almost 50 years, we have not seen that. Our growth has been, 'Can you come here and give us some jobs?' Meanwhile, the wealth was going somewhere else. It wasn't building in York."

Along with the commercial exodus came an exodus of residents. York's population declined by almost a third from 1950 to 2000. It has since inched back up as families pushed out by rising rents in New York and Philadelphia, or those fleeing crime in Baltimore, have landed in the city. But with unemployment approaching 9 percent, York is now a place with epidemic levels of poverty. More than one-third of the city's residents live in poverty, a higher rate than in Baltimore or Philadelphia and twice the poverty rate in New York City.

Nonetheless, Helfrich has high hopes that a new federal incentive package might bring business back to York. So-called opportunity zones, an incentive with bipartisan support, were included in the 2017 federal tax law to lure capital from Wall Street to struggling cities and towns across the country. The Economic Innovation Group (EIG), a D.C. think tank launched by Sean Parker, the founder of Napster and former president of Facebook, worked for four years on the incentive, which is meant to fix a problem that has been evident to economists and mayors for years but has eluded a solution.

That problem worsened when the recession officially ended in mid-2009. The ensuing recovery was uneven. The economic expansion was led by a handful of urban hubs, the rock stars of the recovery. Austin, Los Angeles, New York City, San Francisco, Washington, D.C., and their surrounding metro areas were far outpacing most of the country in job growth. From 2010 to 2017, nearly half of the job growth occurred in the nation's largest 20 metro areas. About half of the net increase in business establishments across the country from 2007 to 2016 took place in either D.C. or New York City. A generation ago, the opposite was the case. Job growth in the 1990s was led by rural and suburban counties, not urban centers. What the post-recession economy has favored — an educated workforce, density and an established startup culture — has left places like York far behind. “The rising tide,” says John Lettieri, president and CEO of EIG, “isn’t lifting all the boats.”

Lettieri, Parker and their colleagues created a blueprint they hoped would help even out jobs and wealth creation across the country. Investors had gotten fat on Wall Street bets. Much of their newfound money was sitting idle. If those funds could be shielded from capital gains, EIG theorized, they could be moved off Wall Street and invested in new ventures in other places.

Their idea was to allow investors to reduce their capital gains exposure in exchange for investment in certain low-income Census tracts to be designated as opportunity zones. For a place to qualify as an opportunity zone, at least 20 percent of its residents have to live in poverty, or the earnings of the residents have to be below 80 percent of the area’s median income. In return for their money, investors would be able to reduce the capital gains tax liability on their investment by 10 percent if they left their money in the zone for five years. If they didn’t move the money for seven years, they would receive a 15 percent reduction in capital gains taxes. If they kept it there 10 years, they would receive a 15 percent reduction in capital gains taxes and escape any liability on gains that came from investment in the zone. Congress bought into the idea. U.S. Treasury Secretary Steven Mnuchin estimated that $100 billion in capital would move off Wall Street as a result of the program.

Governors were allowed to mark 25 percent of the qualifying Census tracts in their states as opportunity zones. In June, the Treasury Department certified more than 8,700 zones across the United States and Puerto Rico. The exact rules are still being set, but investors needed to have their money in the opportunity zone funds by Dec. 31 to take full advantage of the benefit.

Helfrich pounced on the chance to leverage the tax incentives in opportunity zones, hoping they would be enough to overcome the high taxes in the city. He worked closely with Gov. Tom Wolf, himself a York native, to designate five city Census tracts as opportunity zones. As the deadline approached in December, only a handful of investors showed interest in York’s opportunity zones, and most of those weren’t large private equity firms from outside the city, but local investors.

York’s problem attracting outside investment to its opportunity zones has been even more frustrating considering where capital was moving. An opportunity zone fund targeting Chicago raised $105 million in 17 hours in November. When Amazon announced it had picked Long Island City, in the New York borough of Queens, as one of two sites to host the company’s second headquarters, investment sprinted to the opportunity zone that would be adjacent to the tech giant. Goldman Sachs, for example, announced it was putting $83 million into a real estate deal nearby.

Like York, Long Island City was once an industrial hub. The red neon Pepsi-Cola sign on the banks of the East River lit up the front of a bottling plant that churned out thousands of sodas each day. In the 1920s, the boom from industry lured the Bank of Manhattan to build a tower in Long Island City at the foot of the newly constructed Queensboro Bridge. When the bank opened in 1927, it was the tallest building in the borough, a title it would hold for 63 years. The surrounding square near the foot of the cantilever bridge was dubbed the Times Square of Queens.

Long Island City’s fortunes turned, just as they did in York. The bottling plant closed in 1999. The Bank of Manhattan branch was abandoned. The hands on the tower clock stopped ticking. And the slow and steady economic decline took its toll on the residents. As the factories emptied out, the demographics of the surrounding neighborhood shifted. The neighboring housing project went from a mix of white and black working-class people to largely poor residents, according to New York City’s own estimates, and almost exclusively black and Latino.

But unlike York, Long Island City has recovered in the last decade. With Manhattan and Brooklyn rents choking the wallets of the city's young professionals, it has become one of the hottest places in the city for renters, especially affluent white renters. From 2010 to 2015, Long Island City was tied for first place among neighborhoods in New York in its influx of white residents. Median home prices went up 51 percent in the last six years. And rents in the neighborhood are the highest in Queens, according to the real estate firm Zillow.

The old Bank of Manhattan tower is slated to be transformed into office and retail space with a luxury apartment complex right next door. Amazon will make an area already attractive to affluent professionals even more attractive. The company is kicking in $2.5 billion in real estate investment in the neighborhood. But since poverty persists in Long Island City, especially in the housing projects, the area was certified as an opportunity zone in June. The designation allowed Goldman Sachs to cash in on its real estate deal. The company called the timing of its announcement, on the same day as Amazon declared that it would move to Long Island City, a coincidence. And perhaps it was, but analysts see a trend in the actions of major investors. "If you look at the behavior of the real estate industry," says Timothy Weaver, an urban policy assistant professor at the University at Albany, "it is amassing vast amounts of money and directing money to take advantage of the policy." To critics, opportunity zones are threatening to bestow huge grants on communities that don't really need them.

Opportunity zones are the latest in a long series of efforts by the federal government to direct investment to impoverished areas. Since the New Deal, the government has been trying to jumpstart economic growth in portions of the country where the economy was faltering. In the 1970s, the Department of Housing and Urban Development launched Community Development Block Grants and Urban Development Action Grants to revive struggling cities. Those programs were popular with the progressive administrations and congresses that dominated federal politics during that period.

Also in the 1970s, Republicans, led by U.S. Rep. Jack Kemp, began proposing market-driven solutions to the same problems, referring to them most often as enterprise zones. Nearly all of these solutions were based on tax incentives or the loosening of economic regulations. Slightly different versions, under different names, were created and enacted by Democrats in the Clinton and Obama years. But the percentage of Americans living in poverty remained nearly unmoved through all the decades. Equally troubling was the increase in those living in extreme poverty. The number of Americans whose earnings equal less than 50 percent of the federal poverty line has more than doubled in the last 40 years, according to the Census.

Opportunity zones borrows a bit from the playbooks of the previous plans. But there are some significant changes. The market-driven solutions of the last 40 years have been in line with conservative supply-side economic policies. Investment, goes the theory, drives the economy. Cut taxes and investors will use their capital to make more money and, in turn, create jobs. Democrats in the 1980s and 1990s were largely skeptical of supply-side economics. The party insisted that market-driven programs include local hiring and local contracting provisions to make sure jobs were created in the community and the gains made by investors were shared with local businesses. For example, the empowerment zones that were established under the Clinton administration gave businesses a tax credit for hiring employees who lived in the zones. No such provisions exist in the opportunity zone program, despite backing from some prominent Democrats. Urban policy analysts see the program as an unbridled supply-side program. "It's almost a purer version of the original vision," Weaver says. "What happened with the empowerment zones and the enterprise zones is that Congress made compromises that watered them down."

While companies aren't required to hire a certain number of local employees, firms must have 70 percent of their tangible assets (property, materials and goods for sale) within the zone, a regulation designed to keep large retailers such as Amazon and Walmart from cashing in on the tax break. Even so, critics still characterize the program as too wide and unrestricted, noting that hot markets such as Chicago, Los Angeles and New York have already shown the most visible successes. Even their poorer neighborhoods are seen as better bets. That's why Long Island City, not York, Pa., is attracting so much investment. And what critics fear is that the feverish investment in hot markets will lead to displacement of low-income residents. "If these investments are going to be luxury hotels and real estate investments it's not going to help low-income people," says Chris Edwards, director of tax policy studies at the Cato Institute. "It's more likely to displace them."

When EIG designed opportunity zones, the drafters expected that real estate would be — and in their estimate, should be — the first place for investors in the zones to put their money. Businesses would need offices, and workers would need housing. Gentrification was a concern, so the program included a condition that a developer buying a piece of real estate must make an equal investment in improving the property. If developers paid $1 million for a property in a city, they were required to make $1 million in improvements.

However, in the rules released by the IRS in October, the value of the land was taken out of the calculation for necessary improvements on a property. So only the structure, if there is one, will be factored into the amount of improvement necessary to qualify under the program. In York, Helfrich is worried that investors might see his city as a place to buy up real estate and not invest in businesses. Developers have long been buying factories in the city and converting them to condominiums and loft apartments. "We are very aware of the potential pitfalls of this program," Helfrich says. "Our city wants to attract job-providing businesses and discourage those who want to gentrify the neighborhoods in our city."

Despite the market-driven underpinnings behind opportunity zones, libertarian-leaning conservatives are critical of the plan. For one thing, they insist, allowing governors to pick the areas of investment politicizes the program. The original zone map proposed for York included residential neighborhoods. But a lobbying effort by elected officials convinced the governor to move the zones to commercial areas where city leaders wanted the investment to go.

Another concern is that by lumping cities like Chicago, New York and Washington, D.C., with places such as Akron, Ohio; Clarksdale, Miss.; and York, the program is only encouraging more investment in superstar cities. "If you look in Los Angeles and New York City, many of the places that are labeled opportunity zones are places where investment is already happening," says Weaver, the urban policy professor. "And investors are going to get tax breaks on investments that were going to happen anyway."

Not only are the zones in the less attractive markets forced to compete with places such as Long Island City for investment, but the smaller markets are also competing with each other. "There are more than 8,000 Census tracts with the same tax advantage," says Brett Theodos of the Urban Institute. It'll be hard for these eager supplicants to distinguish themselves from one another. It would be simpler, he says, to play it safe and invest in Chicago, New York or Seattle.

Then there's the issue of the Treasury Department rules. One of them states that 50 percent of the gross income generated by a business in a qualified opportunity zone must result from sales made within the zone. That would essentially disqualify all but retail and real estate investment. Lettieri of EIG has been critical of the 50 percent gross revenue rule, saying that if it remains in effect, opportunity zones will fail to spur the kind of economic activity that can revive the areas the program was designed to serve. "The No. 1 outcome we should be driving for here is to support new businesses," Lettieri says. "The gross income rule is damaging to businesses unless you are a laundromat or hardware store who doesn't sell anything online."

The public comment period for the Treasury rules closed Dec. 14. EIG submitted comments in opposition to the 50 percent rule, but as of publication, it was still in the tax code.

The combined result of all this is that Helfrich is fielding only a handful of calls from outside investors. Still, there is some interest. John McElligott is the founder and CEO of York Exponential, a robotics firm that programs, designs and constructs its robots in York. On the day Governing visited the robotics plants, McElligott was set to meet with angel investors about the company's expansion. McElligott wants to construct a $136 million robotics campus on a parcel of land called the Northwest Triangle. Gov. Wolf gave the company $6 million toward the project, but York Exponential is looking to investors for the rest of the capital to create what the CEO believes will transform York into a tech hub for hardware and manufacturing. "We are not going to be a research and development community," McElligott says. "York is going to be less Facebook and more Ford."

The campus, McElligott hopes, will be the tipping point in York's renaissance. Once the new facility is operating, he believes other firms will come to York to compete either in building robots or building the materials to support his businesses' growth. As the opportunity zone program was being developed, McElligott traveled to Washington, D.C., at least once a month to lobby on behalf of York's interest.

The proposed York Exponential campus won't die if the 50 percent gross revenue rule remains in place. McElligott is confident his investors will stick with his vision whether or not they reap the benefits of a tax break. But that might not be the case for the tech firms Helfrich and McElligott would like to see orbiting the campus when it is complete. "The program under the 50 percent rule encourages you to create a pizza shop," McElligott says. "We are trying to create jobs." McElligott and Helfrich want what they describe as middle-income jobs, not retail or restaurant employment. In 2017, retail paid an average of $14 an hour, or roughly $30,000 a year, if the employee worked 40 hours a week and received paid leave, according to the Bureau of Labor Statistics.

Even if the Treasury Department removes the 50 percent rule, investors will need some handholding if they are to see places such as York as genuinely appealing targets. None will want to lose the gains made on Wall Street in a risky business proposition. "Naturally the capital in this program is going to flow to real estate," says Steve Waters, founder and CEO of SMB Intelligence, a firm that provides local government with data and information on how to grow their small business sectors. "It's only going to flow to businesses if it's directed."

Many potential investors are looking to the Treasury right now to finalize the rules governing the program. "Investors are champing at the bit to invest in opportunity zones," says Rebecca Mitich, a partner with Husch Blackwell, a law firm that specializes in using tax credits to develop real estate. "There are huge New York private equity funds and giant fund managers who are ready to go but still want additional guidance to proceed.

Lettieri believes the rules for the program are not set in stone. He and others expect more rules, perhaps a revision of the 50 percent gross revenue rule, to come in the spring. And even as the real estate activity around opportunity zones has been red hot, at what appears to be the expense of commercial business applicants, Lettieri and other backers of the opportunity zone idea believe business capital will begin to come off the sideline in 2019 as the program is better defined. If that doesn't happen and the zones remain largely a benefit for real estate development, their creators believe they won't reinvigorate communities like York. "Real estate is the floor, not the ceiling," Lettieri says. "If the road ends with real estate, that is a big shortcoming."

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