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March 10, 2010

California's Enterprise Zone Program

LEGISLATIVE ANALYST'S OFFICE

Presented to:

Senate Revenue and Taxation Committee

Hon. Lois Wolk, Chair

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Enactment and Benefits

	Hiring Credit	Longer NOL Carryforward Period	Sales and Use Tax Credit	Accelerated Depreciation	Lender Interest Deduction
Enterprise Zones	X	X	X	X	X
Targeted Tax Areas	X	X	X	X	
Local Agency Military Base Recovery Areas	X	X	X	X	
Manufacturing Enhancement Zones	X				

☑ Tax incentive areas—Enterprise Zones (EZs), Manufacturing Enhancement Areas (MEAs), Targeted Tax Areas (TTAs), Local Agency Military Base Readjustment Areas (LAMBRAs)—were selected based largely on socioeconomic characteristics of the area and on the prevailing level of economic distress.

☑ Legislation was enacted in 1984 for EZs, in 1998 for MEAs and the TTA, and in 1993 for LAMBRAs.

☑ Extensive tax benefits are available for each of the areas—including hiring credits, sales and use tax credit, accelerated depreciation, net interest deduction for lenders, expanded use of net operating loss (NOL) carryforwards, and carryforward of unused credits.

- In some cases, there can be preferential treatment for state contracts.
- Additional tax benefits are available for having employees who reside in a Targeted Employment Area.

☑ Tax benefits vary based on the designation of the area, as shown in the table.

Program Usage

- ☑ The total revenue impact on the state is currently in the hundreds of millions of dollars.
  - For all tax incentive programs and for all types of areas, income taxes for tax year 2006 were reduced by around $450 million.
  - Corporation Taxes (CT) accounted for around 60 percent of total revenue reductions and around 30 percent of the returns filed.
  - The number of employees claimed to be employed on tax returns grew from 24,190 to 91,416 between 1999 and 2007.
  - The amount of carryover credits has increased from $48 million in 1997 to $595 million in 2007.
- ☑ The hiring credit is by far the most "expensive" for the state in terms of forgone revenues. In 2007, this accounted for $237 million of the CT revenue reduction attributable to EZs.
- ☑ For the CT, 26 percent of the benefits went to manufacturing and 44 percent to trade and financial services.
- ☑ In 2007, 74 percent of the tax benefits went to companies with assets of $1 billion and over. Sixty percent of the tax benefits went to companies with receipts of $1 million or more.

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Program Trends

- ☑ Usage of the hiring credit and sales and use tax credit has expanded dramatically over the life of the program.
- ☑ The cost to the state of the EZ net interest deduction has also expanded rapidly.
  - For CT taxpayers, this expanded from $4.6 million in 1995 to $34 million in 2007.
  - Tax returns claiming this incentive grew by 161 percent in that period.
- ☑ Tax credits claimed through amended returns totaled $58 million over the years 2005 through 2007. This appears to reflect people who discover, after making certain business decisions, that they were eligible for credits.
- ☑ The number of employees reported on tax returns grew from 24,190 to 91,416 between 1999 and 2007.
- ☑ Nationally, several EZ-type programs have expanded despite their unclear benefits. We note such programs appeal both to those promoting reduced taxation and to those targeting particular populations for specific assistance.

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Program Effectiveness

- ☑ Academic literature on geographic tax incentives in general is rather mixed—with some indicating a positive response and others suggesting no response.

- ☑ Overall, the weight of research suggests that the response may be small in general and may result in revenue losses that are significant relative to the benefits received.

- ☑ That said, there is evidence that some EZs are more effective than others, and that people's incomes can go up even if no new jobs are created. Also, applying for or administering an EZ can indirectly increase the effectiveness of the organization of local development resources to promote business. For example, "red tape" can be reduced.

- ☑ Most research indicates that area programs have little if any impact on the creation of new employment and thus would not have a strong positive impact on the economic base of the state overall.

- ☑ However, such incentives may have an impact on the *distribution* of economic activity.
  - This impact on the location of economic activity is not likely to occur for large regions or states, since other factors are more important such as labor markets and consumer demand.
  - The impact on location is likely to occur in smaller areas—such as metropolitan regions—as businesses are likely to weigh where to locate within a single market.

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Identified Policy Issues

- ☑ ***The Area Approach Is Not Well Tailored.*** We do not believe uniform tax credits are the best way to address the real and diverse problems certain people or places experience. The program's weak results may be due to the different and complex reasons why investment has been pulled out of certain areas or why people without jobs and job openings are not well matched.

- ☑ ***Retroactive Credits.*** The ability of taxpayers to amend past returns and claim hiring credits removes the incentive aspect of the program. In this sense, the program provides more of a reward than an incentive.

- ☑ ***Employee Qualifications.*** If the goal is to increase employment, why restrict credits to only certain types of employees?

- ☑ ***Design Issues.*** The area designation process should be more competitive.

LAO Bottom Line

Because they are expensive and not strongly effective, the area programs should be eliminated or restructured. If the program were eliminated, this would lead to revenue gain of about $400 million in 2010-11 and $470 million in 2011–12.