LAO
65 YEARS OF SERVICE

February 16, 2011

California's Enterprise Zone Programs

L E G I S L A T I V E   A N A L Y S T ' S   O F F I C E

Presented to:

Senate Governance and Finance Committee

Hon. Lois Wolk, Chair

LAO
65 YEARS OF SERVICE

Program Background

- ☑ ***Area Program Tax Benefits.*** About three decades ago, the Legislature began to use the state's tax code to benefit businesses and workers in areas that were deemed to be distressed. The intent was to mitigate the higher costs associated with doing business in those areas and to increase opportunities for certain people.

- ☑ ***Several Types of Areas.*** 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 there. Legislation was enacted in 1984 for EZs, in 1998 for MEAs and the TTA, and in 1993 for LAMBRAs.

Program Background *(Continued)*

☑ ***Areas Located Throughout the State.*** There are now 53 tax incentive areas in California.

☑ ***Various Types of Tax Benefits.*** Extensive tax benefits are or were available for each of the areas as shown in the table.

- Overall, the hiring credits are by far the most important—and expensive—such benefit.
- EZ tax benefits are available for having employees who reside in a Targeted Employment Area.
- An employee can be claimed for a hiring credit for up to five years.
- There are benefits other than those listed below, such as preferential treatment for state contracts.

	Hiring Credit	Longer NOL Carryforward Period[a]	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				

[a] Recent legislation lengthened carryforward periods for all taxpayers.

NOL = net operating loss.

LAO
65 YEARS OF SERVICE

Program Usage

- ☑ ***Rapid Growth in Use of Hiring Credits.*** The number of employees claimed to be employed on tax returns grew from 24,190 to 103,999 between 1999 and 2008. In 2008, 36,976 were claimed as "new" employees.
  - In 2008, the hiring and sales tax credits resulted in $274 million of reduced corporation tax revenues for the state. This is around 60 percent of the total reduction in revenues from the corporation tax and the personal income tax.
- ☑ ***Substantial Benefits for Large Businesses.*** In 2008, around half of the EZ hiring and sales tax credits went to businesses that each had more than $100 million in assets. Around 40 percent of those credits went to businesses with over $1 billion in assets.

LAO
65 YEARS OF SERVICE

How to Evaluate Program Effectiveness

☑ The EZ programs are used extensively. Use, however, is not the same thing as effectiveness. In assessing these programs, the Legislature will need to consider:

- Would more or fewer people have had jobs in the area if the state had used the money differently?
- Were some or many of the jobs for which credits are claimed offset by losses elsewhere?
- Did the programs reward decisions by firms and local governments that would have been made anyway?

LAO
65 YEARS OF SERVICE

Our Assessment of the Program's Effectiveness

- ☑ ***Programs Not Shown to Be Effective.*** Most rigorous research has found that EZs do not create a net increase in jobs or increase the rate of job creation.

- ☑ ***What Might Be Reasons for the Lack of Job Impacts in the Areas?*** These incentives may have an impact on economic growth, the distribution of economic activity, the composition of the workforce, and production decisions. Nevertheless, there are several possible reasons why they do not demonstrate a positive net effect on job creation.
  - For example, favoring qualified workers with the hiring credit may lead to the loss of other jobs.

- ☑ ***Possible Statewide Jobs Impacts Limited.*** Even if an EZ has a positive effect on jobs *locally*, the incentives may just move jobs around the state. When deciding between different states to expand in, other factors can be more important than tax incentives.

Our Assessment of the Program's Effectiveness *(Continued)*

☑ ***The Area Approach Is Not Well Tailored.*** We do not believe uniform sets of statewide tax credits are the best ways to address the real and diverse problems certain people or places experience. These programs' 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. Local governments could better devise portfolios of approaches to suit their particular needs.

☑ ***Retroactive Credits Are Poor Incentives.*** The ability of taxpayers to amend past returns and claim hiring credits removes the incentive aspect of the programs. In this sense, the programs provide more of a reward than an incentive.

☑ ***Current Tax Policies Pick Winners and Losers.*** These programs involve the states favoring certain businesses over others.

☑ ***Yet. . . Some EZs Better Than Others.*** That said, there is some 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.

LAO
65 YEARS OF SERVICE

Governor's Proposal

☑ ***Eliminate Tax Benefits.*** The Governor proposes to eliminate these area program tax benefits, both for newly earned credits and deductions *and* for credits that have been earned in prior years, but have not yet been used.

- Between $1 billion and $2 billion worth of unused credits were carried forward from 2008.
- For example, under the proposal, an employee hired in 2009 and claimed for a credit in 2009 and 2010 could not result in tax benefits for 2011, 2012, or 2013.

☑ ***Over $900 Million of Proposed Budget Solutions.*** The Governor's proposal would lead to a General Fund revenue gain of about $343 million in 2010-11 and $581 million in 2011-12, according to the Department of Finance. (The 2010-11 amounts reflect the administration's new revenue accrual approach.)

65 YEARS OF SERVICE

LAO Bottom Line

☑ ***Recommend Eliminating These Programs.*** Because they are expensive and not shown to be effective, we recommend that the area programs be eliminated.

☑ ***Proposal to Void Unused Credits Raises Questions.*** The Governor's proposal to void unused credits businesses had expected to carry forward raises various issues. Businesses made decisions under the assumption the state would meet its credit commitment. Voiding unused EZ credits not only raises concerns about the state's treatment of businesses that have such credits; it also could weaken incentives provided by other credits.

- As an alternative to voiding existing unused credits, the state could either suspend their use temporarily or limit the amount of net income they could offset in a given year.