# AGENDA
# BUDGET SUBCOMMITTEE NO. 4 ON STATE ADMINISTRATION AND COMMITTEE ON REVENUE AND TAXATION
## ASSEMBLYMEMBER JOAN BUCHANAN, CHAIR
## ASSEMBLYMEMBER HENRY PEREA, CHAIR

## JOINT HEARING ON ENTERPRISE ZONES AND REDEVELOPMENT

**MONDAY, FEBRUARY 7, 2011**
**STATE CAPITOL, ROOM 4202**
**1:00 P.M.**

---

## Enterprise Zones

**Origin and Purpose**

Jason Sisney, Director of State Finance, Legislative Analyst's Office

James Nachbaur, Economist, Legislative Analyst's Office

**Research Results**

Jed Kolko, Research Fellow, Public Policy Institute of California

Charles Swenson, Research Fellow, University of Southern California

**Administration's Proposal**

Mark Hill, Program Budget Manager, Department of Finance

Jay Chamberlain, Financial Research, Department of Finance

**Assessment of Proposal**

Jason Sisney, Director of State Finance, Legislative Analyst's Office

James Nachbaur, Economist, Legislative Analyst's Office

**Public Comment**

## Redevelopment

### Origin and Purpose

Marianne O'Malley, Director of General Government, Legislative Analyst's Office

Mark Whitaker, Senior Fiscal & Policy Analyst, Legislative Analyst's Office

### Administration's Proposal

Mark Hill, Program Budget Manager, Department of Finance

Chris Hill, Local Government, Department of Finance

### Assessment of Proposal

Marianne O'Malley, Director of General Government, Legislative Analyst's Office

Mark Whitaker, Senior Fiscal & Policy Analyst, Legislative Analyst's Office

### Impacts of Redevelopment

La Shelle Dozier, Executive Director, Sacramento Housing and Redevelopment Authority

Jean Ross, Executive Director, California Budget Project

Jean Hurst, Legislative Representative, California State Association of Counties

### Public Comment

# Background on California's Enterprise Zone Program

## Origin and Purpose

California law permits the Department of Housing and Community Development to designate up to 42 Enterprise Zones (EZs) throughout the state, as well as several other types of business incentive areas throughout the state. By providing tax credits and other incentives, the EZ and related programs seek to stimulate business activity in economically distressed regions and to create job opportunities for disadvantaged individuals. Specifically, the EZ Act states:

> It is in the economic interest of the state to have one strong, combined, and business-friendly incentive program to help attract business and industry to the state, to help retain and expand existing state business and industry, and to create increased job opportunities for all Californians.

EZ advocates, including numerous business interests and local administrators, argue the program represents California's best tool for economic development. They cite the fact that the program results in lower costs for businesses operating in these zones and thus attracts economic activity to disadvantaged or distressed areas of the state. EZ critics assert the program offers a poor return on the state's sizable investment largely due to flaws in the program's specific design and implementation or, more fundamentally, the ineffectiveness and inefficiencies inherent in tax incentive programs.

Citing criticisms of the program, the Governor’s Budget for 2011-12 would eliminate all EZ tax incentives for tax years beginning on or after January 1, 2011. The proposal would also eliminate the tax incentives associated with the state's other economic incentive areas described above. The Governor’s budget notes that, within the context of a budget that proposes deep spending reductions across state government, all spending must be scrutinized, including spending through tax expenditures for local economic development. The proposal would eliminate all EZ tax benefits, both for newly earned credits and deductions and for credits that have been earned in prior years and have been carried-forward.

## EZ Program's Tax-Related Incentives

Preferential tax benefits available to businesses in EZs include a variety of special credits, additional deductions, and accelerated depreciation provisions that are available under California’s corporation tax (CT) or personal income tax (PIT). The EZ program components are:

***Hiring Credit.*** The largest EZ-related incentive is the hiring credit. California law provides this credit to taxpayers that employ qualified employees in an EZ during the taxable year equal to: (1) 50% of qualified wages in the first year of employment; (2) 40% of qualified wages in the second year of employment; (3) 30% of qualified wages

in the third year of employment; (4) 20% of qualified wages in the fourth year of employment; and, (5) 10% of qualified wages in the fifth year of employment.

In general, "qualified wages" means wages that do not exceed 150% of the minimum wage. A "qualified employee," in turn, means an individual who meets both of the following requirements: (1) At least 90% of the individual's work for the taxpayer is directly related to the conduct of the taxpayer's trade or business located in an EZ; and, (2) At least 50% of the individual's services for the taxpayer are performed within the boundaries of an EZ.

In addition, a "qualified employee" must fall within at least one of several statutorily designated categories. Listed categories include economically disadvantaged individuals, dislocated workers, disabled individuals, ex-offenders, recipients of certain federal or state aid, members of a federally recognized Indian tribe, and residents of a "targeted employment area" as defined by Government Code Section 7072.

Finally, to qualify for the hiring credit, the taxpayer must obtain a certification (or "voucher") providing that the employee meets the eligibility criteria specified above. Taxpayers are required to retain a copy of this voucher and provide it upon request to the Franchise Tax Board (FTB), the state agency charged with administering the CT and the PIT.

***Sales or Use Tax Credit.*** Taxpayers engaged in a trade or business within an EZ can take a credit equal to the sales or use tax paid during the taxable year in connection with the purchase of qualified property. Qualified property includes specified machinery and machinery parts, data processing and communications equipment, and motion picture manufacturing equipment central to production and postproduction. The total cost of qualified property that may be taken into account for purposes of claiming this credit may not exceed $1 million for PIT filers and $20 million for CT filers. Moreover, the qualified property must be used by the taxpayer exclusively in an EZ.

***Net Interest Deduction.*** California law provides for the deduction of net interest income on loans made to a trade or business located solely within an EZ. For purposes of the EZ net interest deduction, a qualified taxpayer (creditor) is defined as an entity that loans funds on or after the designation date of the EZ to a qualified business (debtor) and receives interest payments thereon. It should be noted that the taxpayer (creditor) does not have to be located in the EZ to take advantage of the net interest deduction; only the debtor needs to operate within the EZ.

***Accelerated Depreciation.*** Existing law allows EZ taxpayers to treat 40% of the cost of specified property as an expense not chargeable to the taxpayer's capital account. Any such cost may be allowed as a deduction for the taxable year in which the taxpayer places the property in service. Such property must be for exclusive use in a trade or business conducted within an EZ.

***Employee Tax Credit.*** Finally, existing law allows an income tax credit equal to 5% of qualified wages, as defined, received by a qualified EZ employee during the taxable year. However, for each dollar of income received by the employee in excess of qualified wages, the credit is reduced by nine cents.

**Program Utilization**

In a March 10, 2010 report prepared for the Senate Committee on Revenue and Taxation, the Legislative Analyst's Office noted the following facts on the EZ program's utilization:

- EZ incentives and those for similar zones reduced state income taxes by approximately $450 million in 2006.
- The number of employees claimed on tax returns grew from 24,190 to 91,416 between 1999 and 2007.
- The amount of carryover credits—credits that can be “banked” and used in subsequent tax years—increased from $48 million in 1997 to $595 million in 2007.
- The hiring credit is by far the most costly EZ program for the state in terms of foregone revenues. In 2007, this credit accounted for $237 million of corporate tax revenue reductions attributable to EZs.
- Among corporate filers, 26% of the benefits went to manufacturing firms and 44% went to businesses engaged in trade and financial services.
- In 2007, 74% of the total tax benefits from all EZ programs went to companies with assets of $1 billion or more.

The FTB annually compiles revenue data and other information relating to the state’s tax expenditure programs. According to FTB data, the cost of the EZ programs has continued to increase in terms of foregone revenues. In 2009-10, the estimated decrease in revenues related to the utilization of these programs was $550 million. Revenue loses in 2010-11 are expected to climb to $630 million and by 2011-12 reach $670 million. While these estimates do not represent full “dynamic” estimates, they do incorporate behavioral responses on the part of the taxpayer.

**Governor's Budget Proposal**

The Governor’s Budget for 2011-12 would eliminate all EZ tax incentives for tax years beginning on or after January 1, 2011. The Administration's proposal would also eliminate the tax incentives associated with similar business incentive areas, including Targeted Tax Areas, Manufacturing Enhancement Areas, and Local Agency Military Base Recovery Areas. The proposed elimination would apply to both newly earned credits and deductions, as well as to unused credits earned in prior years. Local

agencies would be permitted to maintain any applicable local incentives. This proposal is estimated to generate additional state revenues of $343 million in FY 2010-11 and $581 million in FY 2011-12.

The proposal would—together with several other initiatives in the Budget—significantly change the way local development efforts are handled by transferring responsibility and authority to local jurisdictions and their voters. The Administration notes:

> The Budget proposes to make significant shifts in the way funding of local government efforts is handled. These changes are intended to move the responsibility and the authority for local development efforts to the local jurisdictions and their voters. Eliminating state tax benefits for EZs is a fundamental part of this change. Because the primary benefit of these zones is to shift economic activity from one geographic region within California to another geographic region within California, they are not of statewide interest.

To support this assertion, the Administration cites a number of studies and publications finding that EZs have little or no impact on job creation or economic activity. In its proposal, the Administration observes that there is evidence that the benefits of EZ programs go to taxpayers whose behavior has not been affected at all by the EZ program. They point in particular to the phenomenon whereby a taxpayer is informed and avails itself of tax incentives for economic expansion after that economic expansion has already occurred. This is discussed further below in connection with reform efforts.

**Research on Enterprise Zones**

In general, the weight of research evidence with respect to the effectiveness of tax incentives concludes that state taxes can have an impact on business location and investment decisions, but the response is small relative to factors such as labor quality, social and physical infrastructure, and access to markets. Research regarding the specific effectiveness of EZ incentives is somewhat mixed and the results can be dependent on when the study was conducted, the research methodology employed, and the particular types of program incentives available.

As with tax incentives in general, overall EZ incentives appear to generate a limited economic response; however, there are a number of features associated with EZs that suggest that there may be a somewhat different response to EZ incentives than to more general tax incentives. There are a number of studies that have looked at the impact of overall tax reductions in designated EZs. LAO's review of the literature on EZ incentives drew several important conclusions from these studies, including the following:

- Intra-metropolitan location activity is more sensitive to tax differences than is interstate location activity. This indicates that EZs may, to a large extent, merely result in shifting jobs within a state or region rather than increasing the total number of jobs in that state or region.

- EZ incentives are most effective in assisting a targeted area if the EZ does not extend beyond that area. Since EZs may simply result in shifting jobs around, the more narrowly targeted the EZ, the more effective it can be in meeting its objective.

- Hiring credits have a greater impact on job creation than other types of incentives. The existence of credits for labor costs can increase the demand for labor and, assuming a qualified workforce is available, result in job creation.

- Significant tax incentives are required to overcome actual or perceived higher operating costs in an EZ. To overcome the costs associated with poor infrastructure and less productive labor, relatively generous tax incentives must be offered in order to stimulate additional economic activity.

Among the studies that have been conducted in recent years, the most noteworthy include the following:

In *"Do California's Enterprise Zones Create Jobs?"* (Public Policy Institute of California; Kolko and Neumark, 2009), the authors compared employment data of EZs and control areas in order to assess the extent to which EZs have created additional employment. The report concluded that the program has no statistically significant effect on employment. Although it did not look at the effect of EZs on poverty and unemployment, it is unlikely that these would be positively affected in the absence of increasing employment. The study questions the value of the EZ program given that there is a lack of proven benefit to California.

In *"Government Programs Can Improve Local Labor Markets: Evidence from State Enterprise Zones, Federal Empowerment Zones and Federal Enterprise Communities"* (University of Southern California; Ham, Imrohoroglu and Swenson, 2009), the authors used Census tracts focusing on five labor market variables (unemployment rate, poverty rate, fraction of households with wage and salary income, average wage and salary income, and total employment) as a means of analyzing the impact of EZs. The research concludes EZ designation has positive impacts on local labor markets, but impacts of federal programs were substantially larger than state programs. Curiously, the study found California EZs had no significant effect on employment, but did have a significant effect on the unemployment rate, poverty rate, and the proportion with wage and salary income.

In *"State Enterprise Zone Programs: Have They Worked,"* (Upjohn Institute; Peters and Fischer, 2002), the authors generally gave a low grade to state EZs in terms of accomplishing their objectives. The authors conclude that EZs have typically little impact overall on new investment and do relatively little to improve the job prospects of residents of the EZs. The authors do acknowledge heterogeneity in the data and indicate that the success of an individual EZ may be favorable, depending upon specific circumstances.

Other papers from the California Budget Project (CBP), *"Enterprise Zone Program: No Bang for the Buck,"* (2011) and the Legislative Analyst's Office (LAO) *"California's Enterprise Zone Program: Prepared for the Senate Committee on Revenue and Taxation"* (2010), focused on the administrative and design inefficiencies of the program.

- The CBP paper notes that EZ credits do not require the creation of new jobs, the majority of EZ credits is claimed on the basis of residency rather than barriers to employment, the EZs are too large to direct economic activity to the area's most in need, and EZ eligibility criteria are too broad.

- The LAO report identified weakness in the program such as the lack of a narrowly tailored approach, lack of competiveness for area designation, restrictions on types of employees eligible for the credit, and retroactive credits. It concluded the program is expensive and not highly effective and recommends its elimination or restructuring.

**Proposals for Reform**

In recognition of the design or other flaws with EZ incentives, the program has been the focus of several recent reform efforts. While the budget proposal would simply eliminate all EZ-related tax incentives, prior legislative efforts have instead focused on reforming the existing program. As explained below, one of the more notable reform efforts concerns the issue of retroactively certifying employees for the hiring credit.

To qualify for the EZ hiring credit, taxpayers must obtain a voucher demonstrating that each qualified employee meets the eligibility criteria set by law. Existing law does not provide a deadline for obtaining a voucher. Thus, taxpayers can certify employees who worked for them in past years, and then submit claims for a refund to FTB under California's general four year statute of limitations for amending past returns. This has led to a significant increase in the number of businesses obtaining vouchers for all employees found to be qualified and then preparing amended tax returns to claim tax credits for prior years.

Critics of this retroactive vouchering argue that the practice undermines the fundamental purpose of the EZ program, which was designed to *incentivize* businesses to locate in EZs and to hire economically displaced and disadvantaged workers. However, a wage credit can only act as an incentive if the taxpayer is aware of the credit at the time of hiring a new employee. With retroactive vouchering, taxpayers are provided a reward for behavior they would have engaged in absent the credit. SB 974 (Steinberg), would have addressed this issue by requiring taxpayers to obtain certification within 42 days of an employee commencing work.

# Background on Redevelopment in California

## Origin and Purpose

Cities and counties established redevelopment agencies (RDAs), consistent with the California Community Redevelopment Law, which was first enacted in 1945. To assist the financing of redevelopment, the voters in 1952 approved an amendment to the California Constitution, which provides funding from the growth increment of local property taxes to promote the redevelopment of blighted areas. In general, redevelopment is a process that enables local government entities to work towards revitalizing deteriorated and blighted areas in their jurisdiction. According to the Controller, there are 398 active RDAs within the state, operating 749 redevelopment area projects.

When redevelopment began over 60 years ago, its goals were clearance of slums and urban renewal. Over the decades, legislators have expanded the original purposes to include public works to stimulate private investment and develop affordable housing, while focusing on projects to eradicate physical and economic blight. Supporters of the RDAs and their activities cite the successes of the programs in removing impediments to private investment. Critics of the program generally argue that RDA activities exceed the intended purpose of eliminating blight and siphon scarce financial resource from core public services.

The Governor’s Budget proposal would enact major changes in the manner in which local redevelopment is funded, redirecting property tax revenues to schools, cities and counties. The Governor’s proposal notes that evidence indicates most development in RDAs is shifted from elsewhere in the state, and thus there is no statewide interest. It also argues that most of the increase in value of properties in an RDA is due to general increases in property values and that this has resulted in increasing diversion of property taxes away from schools, cities and counties.

## Redevelopment Process

To undertake redevelopment, an RDA develops a plan for candidate areas. RDAs then provide the initial funding to launch development in the project area. The underlying goal is for redevelopment to encourage and attract private sector investment that otherwise would not occur. By doing this, proponents argue that redevelopment serves as a catalyst for private investment by providing the initial plan and seed money that ultimately leads to economic development and a new opportunity for the blighted areas.

For an RDA to undertake redevelopment within a project area, the area must be blighted, as defined in law. A blighted area must be predominantly urban with a combination of conditions that are so prevalent and substantial that they can cause a serious physical and economic burden. In order to qualify for redevelopment under state law, the blight must be both:

- **Physical.** This would include unsafe or unusable buildings, incompatible land use, or inadequately-sized lots in multiple ownership; and,

- **Economic.** This would include stagnant property values, presence of hazardous waste, high vacancy rates, abandoned buildings, lack of necessary commercial activity or a high crime rate.

Once an RDA finds an area blighted, it can use its powers of eminent domain and initiate a capital financing plan. Capital financing of redevelopment projects comes from borrowing.

- The primary source is through the issuance of property tax allocation bonds. These bonds are sold to investors in the capital markets with debt service secured by the diverted property tax increment. Private investors bear the risk if the increment fails to materialize to the extent necessary to pay debt service.

- A secondary source of investment capital is through development agreements with property owners with financing from the county or city within which the RDA lies. These loans are also secured by the property tax increment.

RDAs currently have $25 billion in debt outstanding, consisting of $19 billion in bonds and $6 billion in other borrowing.

**Tax Increment**

Upon its creation, an RDA is eligible to receive the future growth in property taxes from the area. These revenues are known as the property tax increment. Without redevelopment increment, property tax revenues would otherwise go to local schools and other local agencies. RDAs receive most of the growth in property taxes that occurs within their boundaries, although in certain circumstances, some growth is "passed through" to the jurisdictions that provide services through locally negotiated agreements and under state law. Currently, about $1.1 billion is passed through to other agencies.

As redevelopment agencies have expanded their activities, including the use of tax increment financing, they have taken a larger and larger share of property tax revenues. In 1990-91, RDAs received about $1.2 billion in property tax revenues. A decade later in 2000-01, this had grown to $2.1 billion. The amount of the increment is estimated to be $5.2 billion, with $1.1 billion passed-through as noted above.

As the property tax revenues of RDAs increase, the state has had to shoulder an increasing burden of paying more for local K-14 education by making up for the property tax revenues that go to redevelopment agencies. The state uses general fund revenues to make up for the funds that would otherwise have gone to the schools, save for the creation of the redevelopment area. Under the Prop 98 guarantee, the state is required to backfill the difference between what a school district receives in property tax revenues

and what the school district needs to meet its revenue limit. This General Fund backfill amount is roughly $2 billion annually.

The relative state role has increased over time as RDAs have received a growing share of the property tax since the passage of Proposition 13. During the 1977-78 fiscal year, RDAs received 2 percent of all property tax revenues, and in 2008-2009, RDAs received 12 percent of property tax. This statewide average conceals large variations in the percentage of property tax revenue received. For example, in San Bernardino, RDAs received 31 percent of property taxes, while in San Francisco; the amount received by the RDA was only 7 percent of the total.

As noted in the administration's proposal, one reading of the 1952 constitutional amendment implies that the tax increment was solely the amount of the increase in value stemming from redevelopment of specific properties. Over time however, most of the increase in value of all the properties in the redevelopment area has been generally the result of inflation or generalized increases in property values that are unrelated to redevelopment activities.

**Housing Funds**

For over 30 years, state law has required RDAs to set aside 20 percent of their tax increment revenues for affordable housing programs. The funds are held by RDAs in a Low and Moderate Income Housing Fund. RDAs are required to report annually specific information about their housing funds to the state Department of Housing and Community Development (HCD). In the most recent report (2007-2008 fiscal year), RDAs reported that they had deposited $1.8 billion to their housing funds. Expenditures were less ($1.5 billion) than revenues, leading to an increase in reserves. HCD reports that total housing fund equity exceeded $4.7 billion at the end of the fiscal year, according to reports by RDAs.

When RDAs fail to spend their housing funds within the time frames prescribed by law, the unspent money is termed "excess surplus." At that point, the RDA has two years to spend the excess surplus or give the money to the county housing authority. The Governor's proposal (described below) calls for funds that RDAs have reserved for low-moderate income housing to be shifted to local housing authorities for such projects.

**Governor's Budget Proposal**

The Governor's Budget RDA proposal has a number of components. In general it seeks to redirect property taxes back to local public agencies while preserving the ability of local governments to engage in redevelopment activities through other mechanisms. The import elements of the plan are:

- Existing RDAs would be eliminated and successor local authorities would be established.
- Property taxes would be partially shifted away from redevelopment to other local agencies including schools, cities and counties.
- The existing debts and contractual obligations of the RDAs would be first priority on property taxes diverted to RDAs. Successor local agencies would be required to use the property tax that redevelopment agencies would otherwise have received to retire existing debts and contractual obligations.
- A measure would be placed on the ballot to lower to 55 percent the approval requirement for local economic development financing to help provide a substitute for the current redevelopment program.

For the 2011-2012 fiscal year, property taxes would be allocated as follows:

- $2.2 billion for the payment of debt service on outstanding debts and outstanding obligations.
- $1.1 billion will be provided to maintain the existing pass-through payments. These are agreements with RDAs and other local governments regarding allocation of tax increment revenues.
- $1.7 billion would be used to offset general funds costs for Medi-Cal and trial courts.
- $210 million will be distribution on a one-time basis to cities, counties and special districts proportionate to their current share of the countywide property tax.

In subsequent fiscal years, the amounts remaining after payment of the debts and contractual obligations of redevelopment agencies will be distributed to cities, counties, non-enterprise special districts and K-14 schools. Generally, the funds would be distributed to the agencies in proportion to their current share of countywide property tax. As the debts and obligations of redevelopment agencies are retired, the amount of available funds would increase. One issue that has been raised in response to the proposal is how it would relate to the passage of Proposition 22 in 2010, which curtails the state's ability to redirect local property taxes.

**Research on the Impact of Redevelopment Agencies**

The research efforts into the impact of redevelopment are substantial but somewhat limited in their applicability. Much of research has developed around specific approaches to redevelopment, making it difficult to apply to redevelopment efforts in general. Because redevelopment approaches are so varied, the impacts of such efforts are also varied. For example, investment in physical infrastructure improvements could result in much different economic stimulus to the redevelopment areas than other types of investment projects.

The Legislative Analyst's Office has opined that, "No reliable evidence that redevelopment agencies improve overall economic development in California. In contrast, the California Redevelopment Association has opined, "We conclude that, in that year, the combination of construction in (redevelopment) project areas and agency participation in construction outside project areas increased the output of the California economy by $40.79 billion."

There is little question that RDAs do generate economic activity within the project areas. However, the conclusion of LAO and other researchers is based on a lack of evidence that RDAs generate new economic activity for the larger region or state as opposed to just attracting businesses and jobs from others areas of the state. The question also remains as to the costs of funding RDA activities to the exclusion of other public services, including education, which economist generally link to increased long-term economic growth.

**Major Redevelopment Issues**

***Longevity of Redevelopment Areas.*** Redevelopment areas have had a history of being created but never being eliminated. In response, the Legislature created time limits in 1993 legislation, AB 1290 (Isenberg). The time limits were set for the term of the redevelopment plan, the term of the available flow of tax increment moneys, and the term of the agency's redevelopment powers. Subsequent legislation has given the RDAs more flexibility by allowing extension of the statutory time limits under specified circumstances.

***Definition of Blight.*** The law repeatedly underscores the need for the public sector's intervention only when private enterprise cannot redevelop blighted areas. Before redevelopment officials can wield their powers of property tax increment funding and property management (including eminent domain), they must determine if an area is blighted. The definition of blight, and how redevelopment officials apply it in specific local settings, is the pivot around which redevelopment powers turn. Legislators perceived that there was local misuse of state redevelopment law by establishing RDAs for land that was not blighted. As a result, statutory reforms were enacted in 1983, 1993 and 2006 to restrict the use of redevelopment.

***Fiscalization of Land Use.*** The fiscalization of land use occurs when public officials base their land use decisions on development projects' costs and revenue consequences, not on the need for jobs, affordable housing, environmental quality or resource conservation. When the Legislature perceived that local officials were luring big box stores, car dealers, casinos and other sales tax generating land uses into redevelopment project areas, they attempted to curtail this type of development (AB 1290, Isenberg, 1993). A later bill also banned direct redevelopment assistance to casinos (AB 2063, Isenberg, 1996).