CALIFORNIA BUDGET PROJECT

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DOLLAR FOR DOLLAR: CALIFORNIA'S ENTERPRISE ZONE PROGRAM FALLS SHORT

California's Enterprise Zone (EZ) Program has been a matter of debate for years. EZs were designed to provide tax breaks to promote business development and job creation in economically distressed areas, but those breaks have cost the state a total of $4.8 billion in lost revenue since the program's inception and have primarily benefited less than half of 1 percent of the state's corporations – those with assets of $1 billion or more. The annual cost of the EZ Program has grown rapidly over the past two decades and – without program changes – is expected to reach $1 billion in the next few years. Yet the best available independent research finds that the state's EZ Program fails to generate job growth or promote business development – key goals of the program. Recent proposals to reform the program present a critical opportunity to curtail the most costly and inefficient uses of the EZ Program while preserving incentives for economic development. In particular, changes to two key areas of the EZ Program – the awarding of hiring tax credits and the designation of EZs – have the potential to increase the program's effectiveness in creating jobs in the state's most economically distressed areas while curbing the growth in program costs to the state.

The Cost of EZ Tax Credits and Deductions Has Increased Substantially Since the Beginning of the EZ Program

EZs cost the state $721.6 million in 2010, up from just $675,000 in 1986 (Figure 1).[1] From 2009 to 2010, the total annual cost increased by 53 percent, due in part to the expiration of temporary tax credit limitations that had been in effect in 2008 and 2009.[2] On average, the cost of EZ tax credits and deductions has increased by 34 percent *per year* since the program's inception, for a total cost to the state of $4.8 billion. The Franchise Tax Board estimates that the annual cost of EZ credits and deductions will balloon to as much as $1 billion by 2016.[3] The average cost per zone has also grown considerably, from approximately $48,000 in 1986 to $17.2 million in 2010, reflecting the substantially increased use of EZ tax breaks (Figure 2).

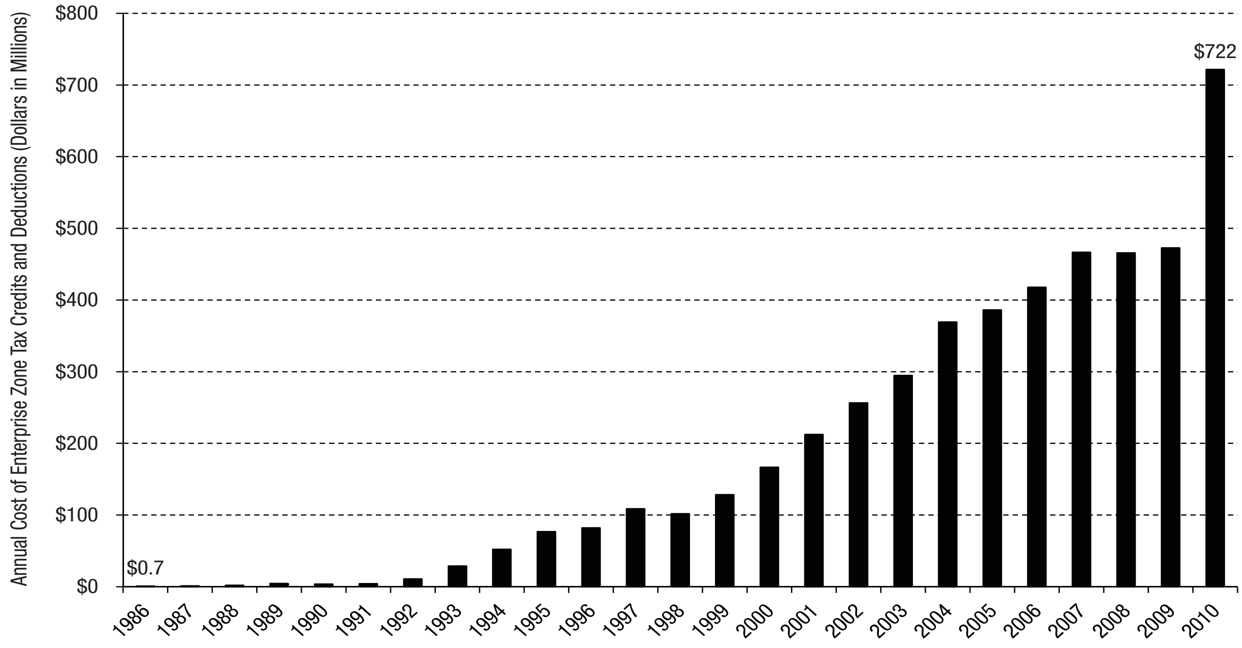
Who Claims Benefits Through the EZ Program?

The cost of the EZ Program continues to grow. As a result, it is important to examine the composition of corporations utilizing the EZ tax breaks as well as the zones that are claiming a share of the tax benefits.

Very Large Corporations Claim Most of the EZ Tax Breaks

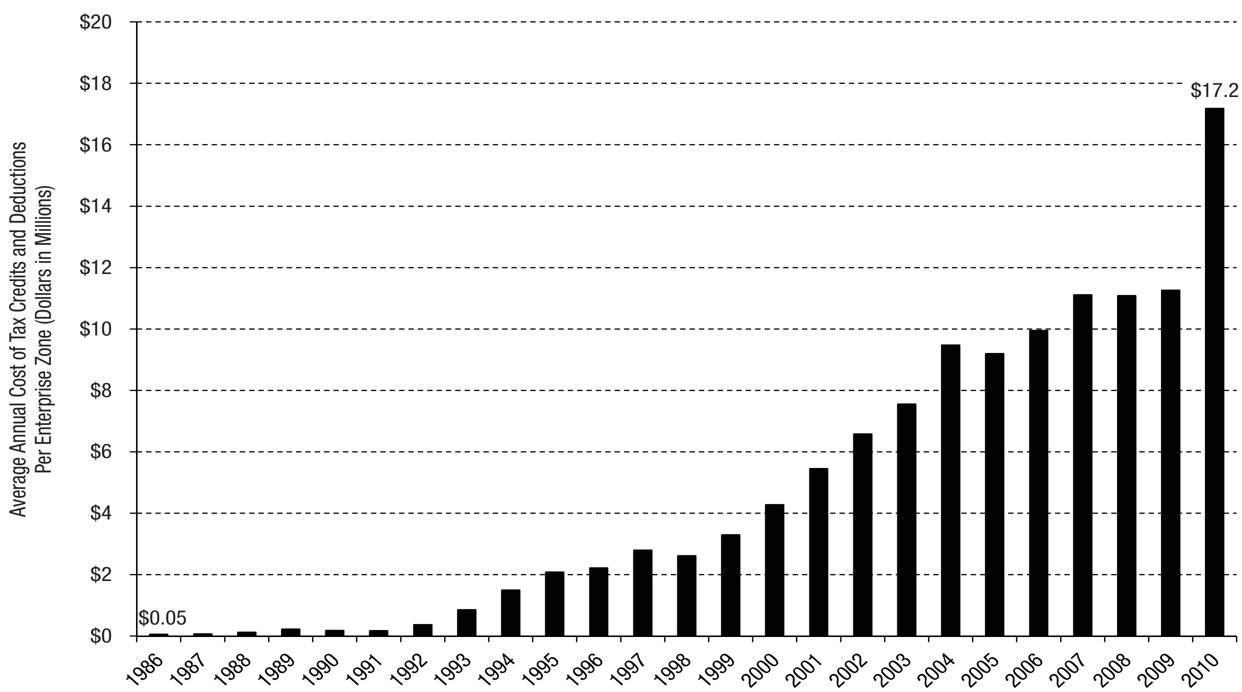
Corporations with assets of $1 billion or more claimed more than two-thirds of the total dollar value of EZ tax credits in 2010 (67.9

Figure 1: The Cost of Enterprise Zone Tax Credits and Deductions
Has Skyrocketed to More Than $700 Million



Source: Franchise Tax Board

Figure 2: The Cost of Tax Credits and Deductions Per Zone Has Increased Substantially



Source: Franchise Tax Board

percent), even though less than half of 1 percent of corporations that file tax returns in California have assets of $1 billion or more (Figure 3).[4] Nearly all of the EZ tax benefits (93.0 percent) were claimed by corporations with assets of $10 million or more, while corporations with less than $1 million in assets claimed only 1.5 percent of EZ tax benefits. In addition, corporations with assets of $1 billion or more claimed an average of $729,000 in EZ credits in 2010, compared to an average of $3,000 for corporations with assets of less than $1 million (Figure 4). Thus, small businesses are not a primary beneficiary of EZ tax breaks.

Very large corporations – those with assets of $1 billion or more – comprise a disproportionate share of corporations claiming EZ hiring and sales and use tax benefits (Figure 5). More than one out of eight very large corporations statewide (13.0 percent) claimed EZ tax credits in 2010, compared to one out of 250 small corporations (0.4 percent). In other words, among corporations that file taxes, very large corporations are over 30 times more likely to claim credits than are small corporations.

Corporations in the San Francisco and San Diego Zones Claim the Largest Share of EZ Tax Breaks

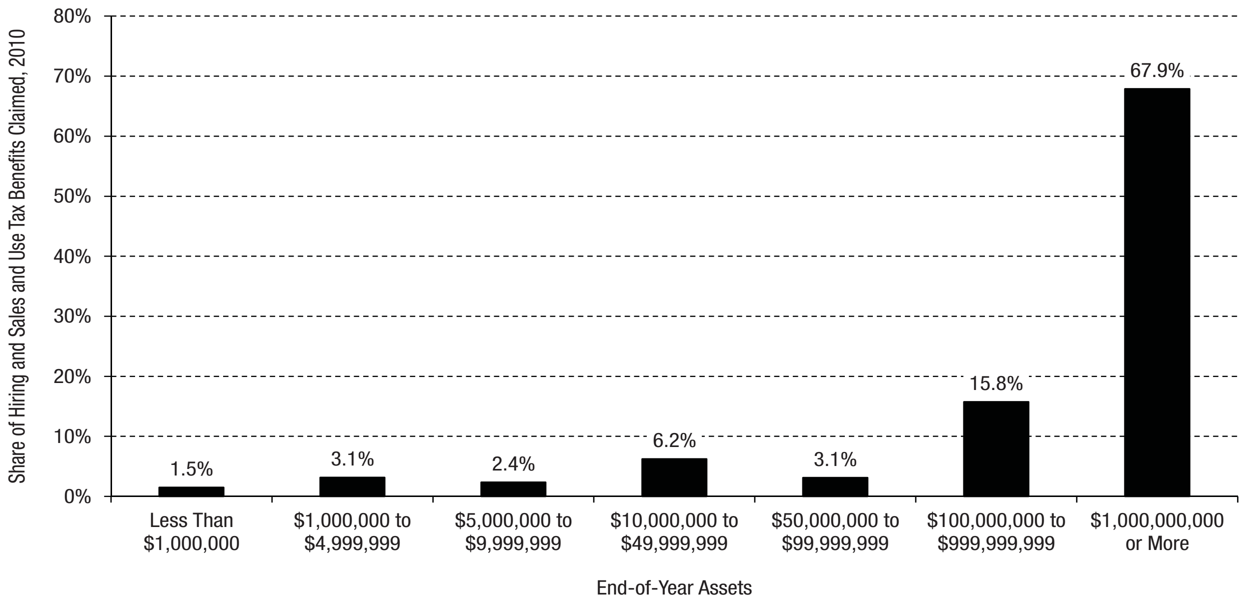
Approximately one out of nine dollars in corporate EZ tax credits (11.2 percent) were claimed by corporations in the San Francisco zone in 2010, at a total cost to the state of $37.8 million (Figure 6).[5] In the San Diego zone, corporations claimed 9.7 percent of the dollar value of EZ tax credits, costing the state a total of $32.8 million. Corporations located in the Los Angeles, Oakland, Long Beach, Stanislaus, and San Joaquin enterprise zones also claimed substantial tax breaks, while EZs in rural areas with very high unemployment rates, such as Calexico, Imperial Valley, and Yuba/Sutter, claimed relatively few tax breaks.

Trade and Service Corporations Are Heavy Users of EZ Credits

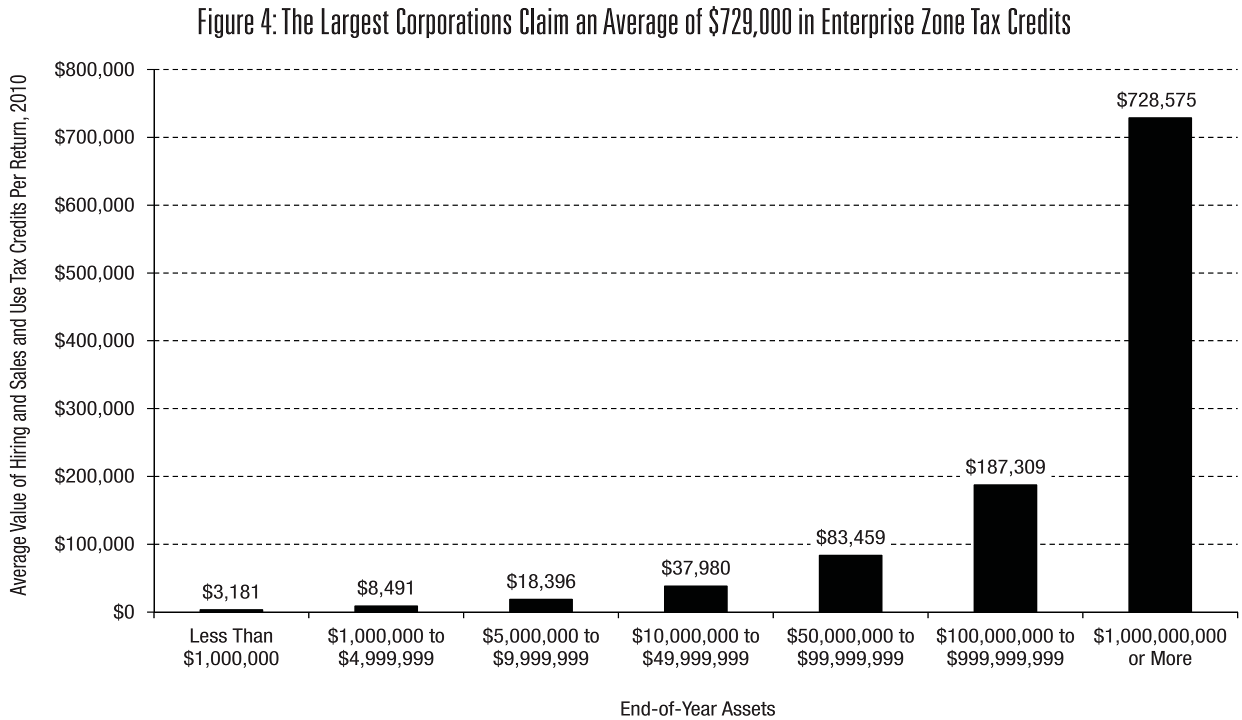
Retail and wholesale trade corporations claimed 30.4 percent of the total dollar value of EZ tax credits in 2010, while service

Figure 3: More Than Two-Thirds of Enterprise Zone Tax Benefits Go to Corporations With Assets of $1 Billion or More

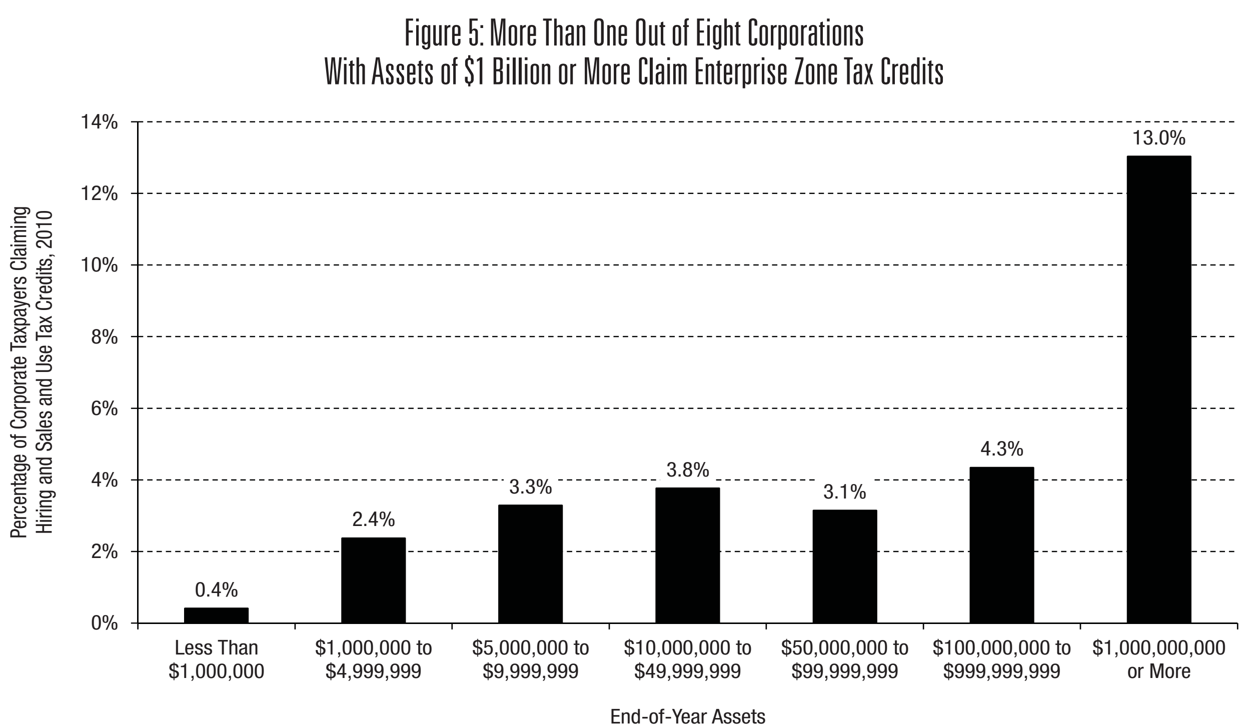
Less Than Half of 1 Percent of Corporations Filing Tax Returns in California Have At Least $1 Billion in Assets



Note: Data exclude companies that file personal income tax returns as well as claims with negative or missing values.
Source: Franchise Tax Board



Note: Data exclude companies that file personal income tax returns as well as claims with negative or missing values.
Source: Franchise Tax Board



Note: Data exclude companies that file personal income tax returns as well as claims with negative or missing values.
Source: Franchise Tax Board

corporations claimed 39.3 percent of the total dollar value – 13.4 percent for financial service businesses, 8.4 percent for information service businesses, and 17.5 percent for other service businesses (Figure 7). Manufacturing corporations claimed 28.6 percent of the total dollar value of EZ credits.

Research Points to Flaws in the EZ Program

California's EZ Program aims to improve targeted economically distressed areas and to expand employment opportunities for select groups of individuals through both business development and job creation.[6] However, nearly 30 years after its creation, the program's effectiveness in achieving these goals is still a matter of debate.[7]

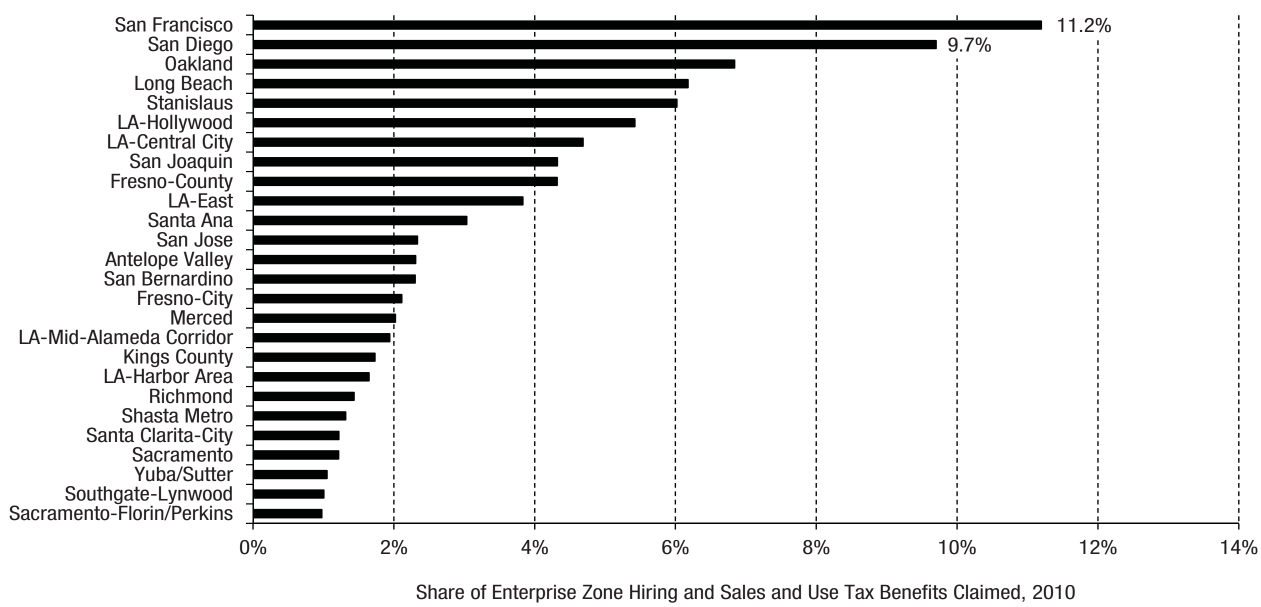
A comprehensive study by researchers at the Public Policy Institute of California found that EZs do not have an effect on business creation or job growth.[8] Although the researchers did not directly assess the impact of EZs on unemployment or poverty, they argued that without an effect on business creation or job growth, EZs are unlikely to reduce either unemployment or poverty.[9] The researchers concluded that "the absence of evidence of a beneficial effect of California's enterprise zones on job and business creation clearly calls into question whether the state should continue to grant enterprise zone tax incentives."[10]

Based on an extensive body of research, the Legislative Analyst's Office (LAO) has argued that EZs are largely ineffective in creating new jobs and has repeatedly recommended that the EZ Program be eliminated or restructured.[11] Numerous LAO reports highlight the EZ Program's flaws, including businesses' ability to claim tax credits for decisions made in prior years, which offers a reward for routine business activity instead of providing an incentive to hire targeted groups of individuals.[12] The LAO concludes that "most research indicates that area programs [such as the EZ Program] 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."[13]

The EZ Hiring Tax Credit Is Costly, Yet Appears to Be Ineffective

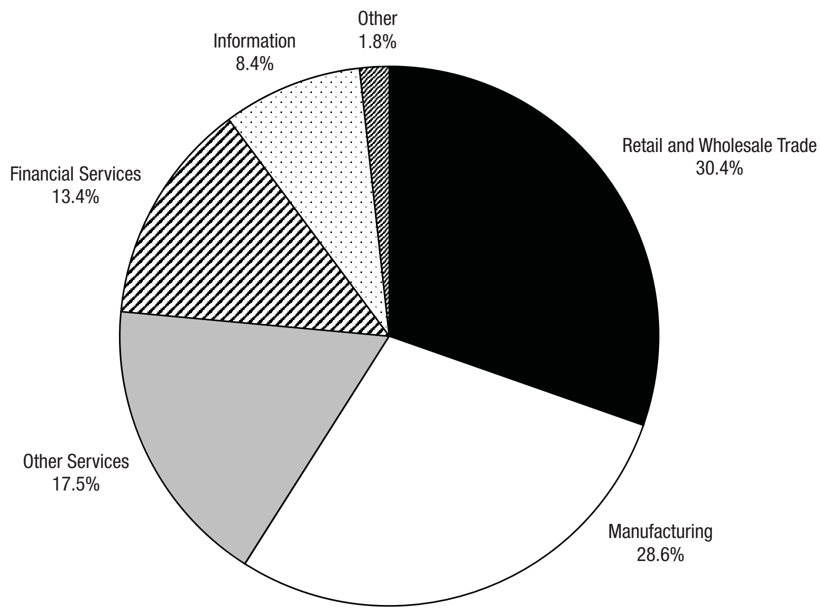
The high cost of the EZ Program is primarily attributable to the hiring tax credit, which cost the state $414.2 million in

Figure 6: The San Francisco and San Diego Enterprise Zones Account for the Largest Shares of Enterprise Zone Tax Benefits



Note: Data exclude credits for companies that file personal income tax returns and companies claiming credits in multiple zones or with unknown locations. Data include expired enterprise zones due to companies' ability to claim credits retroactively. The 29 zones each claiming less than 1 percent of tax benefits are not shown.

Figure 7: Trade and Service Corporations Claim the Majority of Enterprise Zone Tax Benefits



Share of Total Value of Enterprise Zone Hiring and Sales and Use Tax Credits Claimed, 2010

Note: "Other" includes agriculture, construction, mining, and unknown industries. Data exclude companies that file personal income tax returns. Percentages do not sum to 100 due to rounding.

2010 – 57.4 percent of the total cost of the EZ tax breaks.[14] Yet companies can claim hiring credits without creating new jobs, since the credits are for *new hires*, not *new jobs*. In other words, businesses could perpetually claim hiring credits for eligible workers who refill positions that open up due to normal turnover, without creating any net new jobs over the lifetime of the EZ. In effect, the hiring credit rewards companies that have high turnover rates more than it rewards companies that create steady employment and/or new jobs. Moreover, since the amount of the credit declines over time, firms are encouraged to churn their workforce in order to maximize the amount of tax credits claimed.[15]

Companies can also claim hiring tax credits long after individuals begin work, even for workers who are no longer employed at a zone business. By definition, these “retroactive” credits provide bonuses for past actions, but do not encourage businesses to increase or maintain employment in future years and thus do not advance program goals. The California Association of Enterprise Zones estimates that 20 to 30 percent of hiring voucher applications are submitted at least two years after the date of hire.[16] This demonstrates that many businesses make hiring choices independent of EZ hiring tax credits.

Given these flaws in the program’s design, it is not surprising that businesses indicate that EZ tax breaks are ineffective. Nearly half of businesses (47.1 percent) report that the EZ hiring credit “never” or “rarely” influenced their hiring decisions, and 61.5 percent report that it “never” or “rarely” played a role in decisions about whether or not to retain workers.[17]

While EZ Program supporters claim that the program encourages employers to hire disadvantaged individuals, the overwhelming majority of approved credit vouchers – which companies must receive in order to claim the hiring tax credit – are for employees who merely happened to live at an address within a targeted area.[18] Nearly four out of five hiring credit vouchers approved by EZs in 2011 (79 percent) were for residents of Targeted Employment Areas (TEAs), regardless of their income or other characteristics.[19] Several other hiring credit eligibility categories also enable businesses to claim credits for workers regardless of whether they face barriers to employment.[20]

EZ Designation Policies Undercut the Program’s Ability to Target Economic Activity

The ability of EZs to encourage economic activity in the state’s most distressed areas depends on zone designation being limited to these communities. The criteria for qualifying as an EZ have varied throughout the program’s existence and have at times been changed to increase the likelihood that specific areas would be granted EZ status. Current state law includes EZ criteria that do not adequately measure an area's overall economic well-being, such as "a history of gang-related activity, whether or not crimes of violence have been committed."[21] Moreover, state law does not require EZs to substantiate economic distress to retain their original 15-year designation or to expand. This means that EZs can include neighborhoods that are not economically distressed. An analysis of census tracts within the San Francisco EZ, for example, revealed that the majority of tracts failed to meet at least two economic distress criteria, as required for EZ eligibility.[22]

State law currently limits the expansion of an EZ to 15 percent of the total area at the time of original zone designation.[23] However, zone *redesignation* offers the opportunity for zones to expand by more than the 15 percent allowed by state law. From 2000 to 2010, the average size of EZs increased by almost 500 percent as a result of zone redesignation, which can include combining multiple zones into a single EZ, known as zone aggregation. For example, the San Diego, Los Angeles, and Sacramento zones increased in size by 11, 12, and 22 times their original areas, respectively, due to aggregation of zones during the redesignation process.[24] The aggregation and expansion of zones during the redesignation process undermines the EZ Program's ability to select zones in the state's most economically distressed areas through a competitive process.

Finally, targeted zone designation is meant to ensure that benefits are directed to distressed communities. However, EZs are so prevalent that about one out of 12 California workers are employed at a business located in one of the state's zones. Additionally, employment within at least seven EZs represents anywhere from one-quarter to more than one-half of total employment in the counties in which these EZs are located.[25]

Proposed Changes to EZ Program Offer Opportunities and Alternatives for EZ Reform

The EZ Program has been a matter of debate for years. Opponents of the EZ Program question the efficacy of the program in meeting its goals, claiming that EZs have resulted in a poor return on the state's investment in terms of foregone revenue. On the other hand, EZ proponents cite the program as a successful local economic development incentive and offer anecdotal evidence that EZs provide benefits locally and statewide. In addition, there are currently EZs in more than 70 percent of all Assembly and State Senate districts, attesting to a program with a broad statewide political constituency.[26] As a result, reforming EZs is a challenging task.

In recent years, Governor Brown and the Legislature have worked to reform the EZ Program. Governor Brown called for the elimination of the EZ Program in his proposed 2011-12 budget, but the Legislature's lack of action on the proposal prompted the Brown Administration to begin exploring options for regulatory reform in late 2011.[27] Various reforms were included in the Governor's proposed 2013-14 budget, but were significantly altered in the May Revision. The May Revision proposes to substantially restructure the EZ Program by narrowing eligibility for the EZ hiring tax credit to a smaller set of target populations, expanding the sales and use tax credit for the purchase of manufacturing and biotech research and development equipment statewide, and creating the California Competes Recruitment and Retention Fund, which would be administered by the Governor's Office of Business and Economic Development (GO-Biz) and provide tax credits for business investment and job creation throughout California.

In addition, a number of bills have been introduced in the Legislature aimed at improving the efficiency and effectiveness of the EZ Program, while preserving tax benefits for businesses operating within EZs. For example, recent proposals attempted to refine the hiring tax credit by requiring the creation of net new jobs, eliminating retroactive vouchering, and removing TEA residency from the list of qualifying criteria for receiving a credit voucher.[28] Other proposals in recent years attempted to improve zone designation by restricting new zone designations to areas with low-income census tracts, limiting the size of new zones, and putting in place several new evaluation measures linked to the elimination of poor-performing zones.[29] The most recent substantive change to the EZ Program occurred in 2006 with the passage of AB 1550 (Arambula), which allowed for noncontiguous zone boundaries, required the update of TEA boundaries within 180 days of new census data becoming available, allowed EZs to continue to operate with conditional designation, and established new audit and reporting requirements.

Despite the challenges of reforming EZs, the current policy debate offers the opportunity to significantly restructure the program to curb the most inefficient and costly aspects of EZs. Two areas of the EZ Program are especially important targets for improvement: the hiring tax credit and zone designation.

As outlined earlier in this brief, the hiring tax credit is the primary factor underlying the soaring cost of the EZ Program. Narrowing the focus of the hiring tax credit is essential to containing the increasing costs of the program. Recommended changes to this tax credit include:

- **Discontinuing retroactive hiring credits.** Retroactive hiring credits cause the state to lose tax revenues without providing an incentive for future hiring. Discontinuing retroactive hiring credits would ensure that companies are not rewarded for routine business decisions.

- **Requiring businesses to increase employment as a condition of claiming hiring credits.** Hiring credits should encourage companies to create new jobs, not reward these businesses simply for refilling existing positions.

- **Eliminating TEA residency as a qualifying criterion.** Eligibility for hiring credits should be based on whether workers face one or more barriers to employment, not where they live. Employers can claim hiring credits for Targeted Employment Area residents who are truly disadvantaged through various criteria other than residency, such as eligibility for certain income-support or job-training programs.

- **Changing the credit formula to discourage job turnover.** The formula for the hiring tax credit should be altered so that the credit either has the same maximum value per year or increases in each of the five years in which a company can claim the credit for an individual worker. Under the current formula, the maximum value of the credit begins at half of 150 percent of the minimum wage and then declines for each additional year a worker remains at a company.[30] Eliminating the year-to-year decline for the credit could discourage job turnover.

As currently structured, the EZ Program does not effectively target areas of the state that are most in need of job growth, new businesses, and assistance with economic development. In addition, EZs generally cover too large of an area to effectively direct business activity to the state's distressed communities. Recommended changes to the zone designation process include:

- **Restricting zone designation to the most economically distressed communities.** Eligibility criteria should be defined that are easily measurable and reflect the economic distress of proposed zones, including measures of the unemployment rate, median income, and poverty rate. Specifically, census tracts within proposed zones should have an unemployment rate that is substantially and persistently higher than the statewide average, a median income that is substantially and persistently lower than the statewide median, and/or a poverty rate that is substantially and persistently higher than the statewide average. Current criteria that do not provide adequate measurements of an area's overall economic well-being should be removed.

- **Allowing zones to expand only into adjacent areas that are economically distressed.** The state should verify that zone expansions include only those areas that meet the eligibility criteria for economic distress.

- **Terminating zones that are found to abuse the system.** The state should establish rigorous auditing procedures and quality-control standards for EZs. Zones that do not meet or are found to willfully disregard these standards should be terminated immediately.

- **Reassessing zones periodically and terminating zones that are no longer economically distressed.** After the initial zone designation period has lapsed, zones should be reassessed, and only the zones that continue to meet designation criteria should be eligible for an extension. Zones that no longer meet eligibility criteria after the initial zone designation period should be terminated.

Conclusion

California's EZ Program aims to improve targeted economically distressed areas and to expand employment opportunities to select groups of individuals through business development and job creation. These are laudable goals, especially as California recovers from the Great Recession – the deepest economic downturn in generations. However, research repeatedly demonstrates that the EZ Program has serious flaws, and critics continue to question the EZ Program's ability to have an effect on job growth and employment in light of its shortcomings.

The mounting cost of the EZ Program illustrates that reform is warranted, particularly at a time when so many vital public services have been hollowed out by state budget cuts. Reforming EZs would boost state revenue, thus allowing for investment in other public systems and services that prepare California for the future and help lay the groundwork for broadly shared prosperity.

Kristin Schumacher prepared this Budget Brief. *The CBP was founded in 1994 to provide Californians with a source of timely, objective, and accessible expertise on state fiscal and economic policy issues. The CBP engages in independent fiscal and policy analysis and public education with the goal of improving public policies affecting the economic and social well-being of low- and middle-income Californians. General operating support for the CBP is provided by foundation grants, subscriptions, and individual contributions. Please visit the CBP's website at www.cbp.org.*

ENDNOTES

[1] These amounts include tax breaks claimed by businesses that file corporate income tax returns as well as businesses, such as sole proprietorships and partnerships, that file personal income tax returns.

[2] The 2008-09 budget agreement addressed a $24.3 billion budget deficit in part by temporarily prohibiting businesses and individuals from using tax credits to reduce their taxes by more than 50 percent.

[3] Franchise Tax Board, *EZ and Program Area Data,* handout for May 9, 2013, Senate Budget and Fiscal Review Committee, Subcommittee #4 on State Administration and General Government hearing.

[4] Data exclude companies that file personal income tax returns and returns with negative or missing values.

[5] The data reported in this section exclude credits for companies that file personal income tax returns and companies claiming credits in multiple zones or with unknown locations.

[6] Government Code, Section 7071.

[7] Legislative Analyst's Office, *California's Enterprise Zone Program* (March 10, 2010), p. 4.

[8] Jed Kolko and David Neumark, *Do California's Enterprise Zones Create Jobs?* (Public Policy Institute of California: June 2009), p. 1. The study analyzed employment trends in EZs from 1992 to 2004 – a period that spans ups and downs of the economy.

[9] Jed Kolko and David Neumark, *Do California's Enterprise Zones Create Jobs?* (Public Policy Institute of California: June 2009), p. 21.

[10] Jed Kolko and David Neumark, *Do California's Enterprise Zones Create Jobs?* (Public Policy Institute of California: June 2009), p. 22. In addition, the study found that "the enterprise zone program has no effect on … the share of employment in low-wage industries and the share of employment in manufacturing" (p. 17). The study also found that the number of businesses located within EZs declined, which, given that employment in EZs remained the same, implies that business establishments became larger (p. 15). Other studies of California's EZ Program tend to base their conclusions on flawed methodology. For a discussion of these issues, see David Neumark and Jed Kolko, *Do Enterprise Zones Create Jobs? Evidence From California's Enterprise Zone Program*, National Bureau of Economic Research Working Paper 14530 (Revised January 2010), pp. 1-4.

[11] See Legislative Analyst's Office, *California's Enterprise Zone Program* (March 10, 2010), p. 5; Legislative Analyst's Office, *California's Enterprise Zone Programs* (February 7, 2011), p. 8; and Legislative Analyst's Office, *California's Enterprise Zone Programs* (May 9, 2013), p. 8.

[12] See Legislative Analyst's Office, *California's Enterprise Zone Program* (March 10, 2010), p. 5; Legislative Analyst's Office, *California's Enterprise Zone Programs* (February 7, 2011), p. 6; and Legislative Analyst's Office, *California's Enterprise Zone Programs* (May 9, 2013), p. 7.

[13] Legislative Analyst's Office, *California's Enterprise Zone Program* (March 10, 2010), p. 4.

[14] The Franchise Tax Board (FTB) does not report lost revenues separately for the hiring credit and the sales tax credit, but FTB staff suggest that the sales tax credit costs the state significantly less than the hiring credit. Personal communication with the FTB (April 10, 2013).

[15] Revenue and Taxation Code, Section 17053.74(a). The maximum value of the hiring credit begins at half of 150 percent of the minimum wage and then declines for each additional year that a worker remains at a company. Companies can claim hiring credits for individual workers for up to five years. The maximum value of the hiring credit is $37,440.

[16] Department of Housing and Community Development, *Initial Statement of Reasons: Enterprise Zone Program Regulations* (January 2013), p. 31.

[17] Nonprofit Management Solutions and Tax Technology Research, LLC, *Report to the California Department of Housing and Community Development on Enterprise Zones* (August 18, 2006). These results may actually overstate the impact of the EZ Program given that businesses that value EZ tax breaks may have been more likely to reply to the survey and would have had an incentive to exaggerate the impact those tax breaks had on their decisions. See California Budget Project, *New Study Overstates Effectiveness of Enterprise Zones* (August 2006).

[18] Revenue and Taxation Code, Section 17053.74(b). State code outlines numerous "hard-to-hire" categories, in addition to individuals that reside within TEAs, which qualify an employee for a hiring voucher. The "hard-to-hire" categories include individuals eligible for job training programs, economically disadvantaged individuals, dislocated workers, disabled individuals, veterans, ex-offenders, individuals of Native American descent, and/or individuals receiving, or eligible for certain cash assistance programs and/or CalFresh food assistance.

[19] Department of Housing and Community Development, *Initial Statement of Reasons: Enterprise Zone Program Regulations* (January 2013), p. 7. TEA residency allows employers to claim tax credits based solely on where a worker lives and not on any objective measure of whether the individual faces a barrier to employment. A TEA can include all or part of the zone itself, as well as additional areas that may or may not be adjacent to the zone. TEAs can only include census tracts in which more than half of residents have low incomes, defined as those who have incomes at or less than 80 percent of the area median. This definition allows a zone located in an area with high incomes to include census tracts that are not economically distressed in its TEA. For example, if a zone is located in an area with a median income of $100,000, the TEA could include census tracts where more than half of the residents have incomes of $80,000 or less. Finally, TEA voucher applications do not require the same level of documentation as other hiring categories, making it far easier to submit TEA voucher applications. See California Budget Project, *California's Enterprise Zones Miss the Mark* (April 2006), pp. 8-10.

[20] For example, in the past EZs have used an exception in the eligibility guidelines for the now-defunct Job Training Partnership Act (JTPA) Program to approve credit vouchers for individuals without documented economic disadvantage. The Workforce Investment Act, which replaced the JTPA Program in 2000, places a high priority on "universal access" and thus a lower priority on targeting services to disadvantaged persons. See California Budget Project, *California's Enterprise Zones Miss the Mark* (April 2006), pp. 10-12.

[21] Government Code, Section 7072(c). Eligibility criteria also include having at least 70 percent of public school children *in the county* in which the EZ is located participating in the federal free lunch program. However, participation in this program is difficult to measure and may reflect schools' success in enrolling children in the program. Moreover, county participation rates may not reflect conditions within a particular zone, particularly in large urban counties.

[22] California Budget Project, *California's Enterprise Zones Miss the Mark* (April 2006), p. 15. This analysis was based on updated data from the 2000 Census. Assembly Bill 1550 (Arambula, Chapter 718 of 2006) required local jurisdictions comprising EZs to revise the boundaries of TEAs within 180 days of new US Census Bureau data becoming available. See Government Code, Section 7072(i).

[23] Government Code, Section 7074. Once designated, large EZs can expand their geographic boundaries by up to 15 percent, while smaller EZs – those measuring 13 square miles or less – can expand by up to 20 percent.

[24] Senate Floor analysis of SB 133 (April 3, 2013).

[25] Jed Kolko and David Neumark, *Do California's Enterprise Zones Create Jobs?* (Public Policy Institute of California: June 2009), p. 7. The authors utilized data from 2004 for their analysis. From 2006 to 2009, many EZs were redesignated, including the expansion of a number of EZs. As a result, the range of employment in this study may underestimate the current share of individuals employed within an EZ.

[26] Assembly Jobs, Economic Development and the Economy Committee, *Analysis of Assembly Bill 28* (April 23, 2013).

[27] Department of Housing and Community Development, *Initial Statement of Reasons: Enterprise Zone Program Regulations* (January 2013), p. 1.

[28] See, for example, AB 1139 (J. Pérez, 2009) and SB 434 (Hill, 2013).

[29] See, for example, AB 1411 (V. Manuel Pérez, 2012), AB 28 (V. Manuel Pérez, 2013), and SB 133 (DeSaulnier, 2013).

[30] Revenue and Taxation Code, Section 17053.74(a).