

CALIFORNIA BUDGET PROJECT

CALIFORNIA'S ENTERPRISE ZONES MISS THE MARK

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David Carroll prepared this report with assistance from Jean Ross. The California Budget Project (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. Support for the CBP comes from foundation grants, publications, and individual contributions.

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EXECUTIVE SUMMARY

California's Enterprise Zone (EZ) Program provides hundreds of millions of dollars each year in tax breaks to companies located in 42 areas across the state. The cost of the program has skyrocketed, yet the effectiveness of the tax breaks is tenuous, at best, and companies claim tax breaks without demonstrating that they create new jobs. Moreover, zones lack careful targeting: about one out of eight California employees works in an EZ, and zones include some of the most prosperous areas in the state.

This report makes five key findings:

1. **The cost of the Enterprise Zone Program has increased substantially.** The state's annual revenue loss due to the program grew nineteen-fold between 1993 and 2003, from \$15.6 million to \$299.3 million.
2. **California's Enterprise Zone Program fails to effectively target areas most in need of assistance.** The number of zones prevents the program from effectively directing economic activity to the areas most in need. Corporations in urban areas, such as San Francisco and Los Angeles, claim a high proportion of zone tax breaks. In contrast, EZs in Calexico, Delano, and Shafter, which are in rural areas with very high unemployment rates, account for a relatively small share of the program's costs.
3. **The Enterprise Zone hiring tax credit rewards businesses that do not hire workers with barriers to employment or create new jobs.** Nearly two-thirds (64.8 percent) of hiring credit vouchers approved by EZs in 2004 were for workers who merely happened to live in the right neighborhood, not on the basis of a specific barrier to employment. In contrast, only 2.7 percent of approved hiring credits were for workers who were either participants in or eligible for income support programs.
4. **The Enterprise Zone hiring credit is prone to abuse.** EZ businesses can seek approval for hiring credit vouchers from the EZ most willing to approve them. A recent audit found that more than half (61 percent) of vouchers approved by the Oakland EZ were for companies located in other EZs.
5. **Enterprise Zone eligibility criteria are overly broad.** Areas can qualify as an EZ, for example, if they "have a history of gang-related activity," whether or not violent crimes have actually been committed. In addition, state law allows EZs to expand into areas that are not economically distressed.

Twenty-three of the state's 42 enterprise zones will sunset in 2006 or 2007. This provides the Legislature an opportunity to

review the program thoroughly and make changes to improve the efficiency and accountability of the program. This report highlights specific changes to the program that would help ensure that the state's tax dollars are spent responsibly.

Reduce the Size of the Enterprise Zone Program

- Substantially reduce the number of zones.
- Reassess zones every five years and terminate zones that are no longer economically distressed.
- Require local governments to share in the cost of EZ tax breaks.

Reform the Hiring Tax Credit

- Eliminate Targeted Employment Area residency as a criterion for hiring credit eligibility.
- Eliminate hiring credit eligibility categories that are not linked to barriers to employment.
- Allow businesses to claim hiring credits for Workforce Investment Act (WIA) participants only if they are low-income participants in WIA intensive services.
- Require businesses to increase employment as a condition of claiming hiring credits.
- Change the hiring credit formula to discourage job turnover.
- Require proof that an employee performs at least half of his or her work in an EZ in order for a business to claim a hiring credit for that employee.
- Adjust the value of the hiring credit based on the amount of work an employee performs in an EZ.

Improve Accountability of the Hiring Tax Credit

- Allow EZ administrators to approve hiring credit vouchers only for businesses located within their zone.
- Eliminate the ability of businesses to claim retroactive hiring credits.
- Allow businesses to claim a hiring credit based on a worker's eligibility for an income support program only if the agency or department responsible for the program certifies the worker's eligibility.
- Terminate the designation of zones that willfully abuse program rules.
- Clearly define the types of workers who qualify businesses for hiring credits and delete references to obsolete programs.

Limit Enterprise Zone Designation to the Most Economically Distressed Areas

- Restrict zone designation to the most economically distressed communities.
- Prioritize zone designation for areas with strong economic development strategies.
- Allow zones to expand only into adjacent areas that are economically distressed.
- Require EZ Program regulations to reflect eligibility requirements contained in state law.

INTRODUCTION

California's Enterprise Zone (EZ) Program provides tax breaks to economically distressed areas to promote business development and job creation. California's original EZ law created 10 zones in 1984. The Legislature also enacted the Employment and Economic Incentive Act in 1984, which created nine Economic Incentive Program Areas. The two programs were later merged and, over time, the Legislature has expanded the number of EZs to the current level of 42 (Appendix A). EZs are designated for 15 years; a 1998 measure, however, allowed EZs designated prior to 1990 to receive a five-year extension, for a total of 20 years.¹

EZ designation allows businesses located within the zone's borders to claim a variety of state tax breaks (see below). Several other state programs also provide tax breaks for investment in targeted areas, including eight Local Agency Military Base Recovery Areas (LAMBRAs), a Targeted Tax Area (TTA) in Tulare County, and two Manufacturing Enhancement Areas (MEAs).² This report focuses on EZs because they greatly outnumber other types of targeted areas and because the designation of 23 of the state's 42 zones is set to expire in 2006 or 2007.

KEY FINDINGS AND RECOMMENDATIONS

Finding 1: The Cost of the Enterprise Zone Program Has Increased Substantially

The cost of tax credits and deductions has increased substantially since the beginning of the EZ Program. EZs cost the state at least \$299.3 million in 2003 and a total of \$1.5 billion since 1986 (Figure 1).³ The state's revenue loss grew nineteen-fold between 1993 and 2003, despite the fact that only four EZs were added during that period. As a result, the average cost per zone has increased substantially due to increased use of EZ tax breaks (Figure 2). Each zone on average cost the state \$7.7 million in 2003. In contrast, in 1983, the Franchise Tax Board estimated that tax breaks for the original 10 zones could result in lost revenues "in the millions."⁴ Actual losses averaged less than \$1 million per zone until 1996.

Finding 2: California's Enterprise Zone Program Fails to Effectively Target Areas Most in Need of Assistance

The EZ Program does not target the state's most distressed areas and is too large to effectively direct business activity to the areas most in need. Researchers caution that for EZs to be effective, the program must be carefully targeted.⁵ Thus, the ability of EZs to encourage economic activity in the state's most distressed areas requires that zone designation be limited to those communities. However, EZs are so prevalent that about one out of eight California employees works at a business located in one of the state's zones.⁶

How Do Businesses Benefit from EZs?

Businesses located within EZs are eligible for a number of state tax breaks. These include:

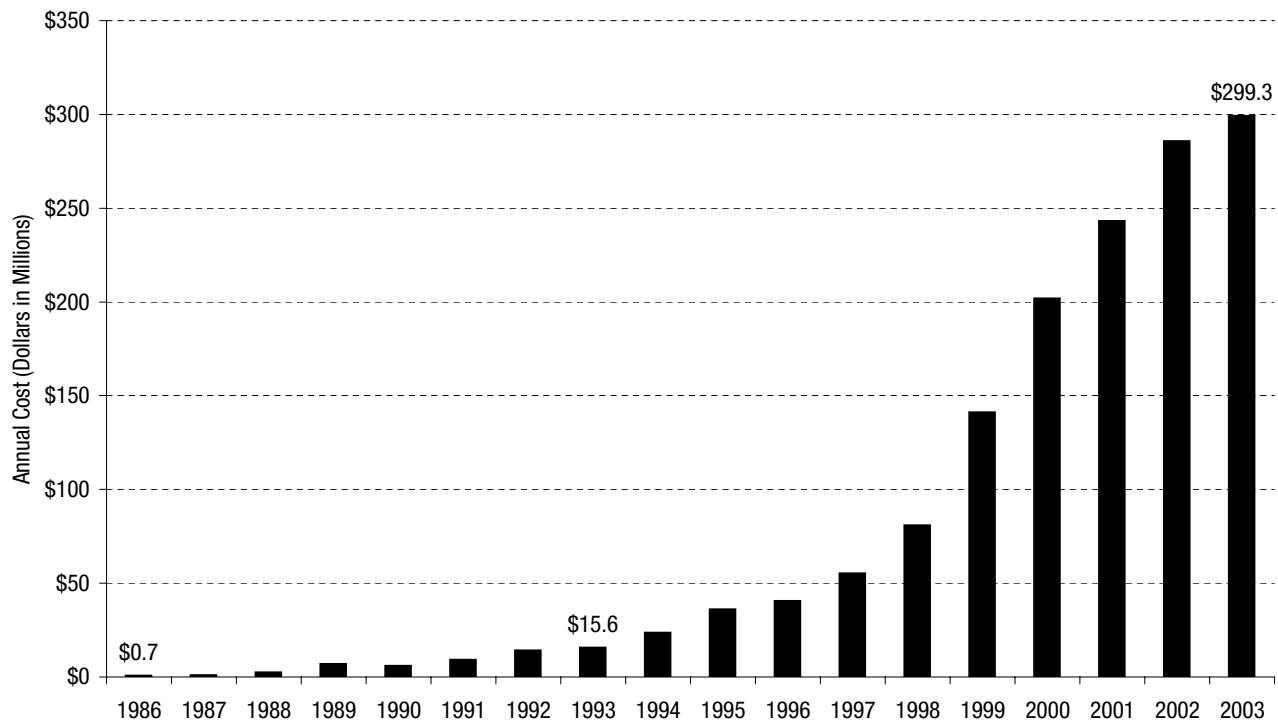
- Tax credits for hiring certain categories of individuals;
- Tax credits for sales taxes paid on the purchase of qualified machinery and parts;
- An extension from 10 to 15 in the number of years in which businesses can "carryforward" net operating losses into future years to reduce taxable income;
- Increased ability to "expense" the cost of certain investments, so that companies can deduct the full cost of certain purchases rather than depreciating them over a number of years; and
- Preferential treatment when bidding on state contracts.

Financial institutions can deduct the interest paid on loans made to businesses within an EZ. In addition to tax breaks, state law encourages, but does not require, local governments to provide assistance to businesses located in EZs. Local assistance may, but is not required to, include elimination of local permits and fees, low interest loans, and employee training for businesses investing in EZs.

Corporations in the San Francisco Bay Area and Los Angeles Are High Users of EZ Tax Breaks

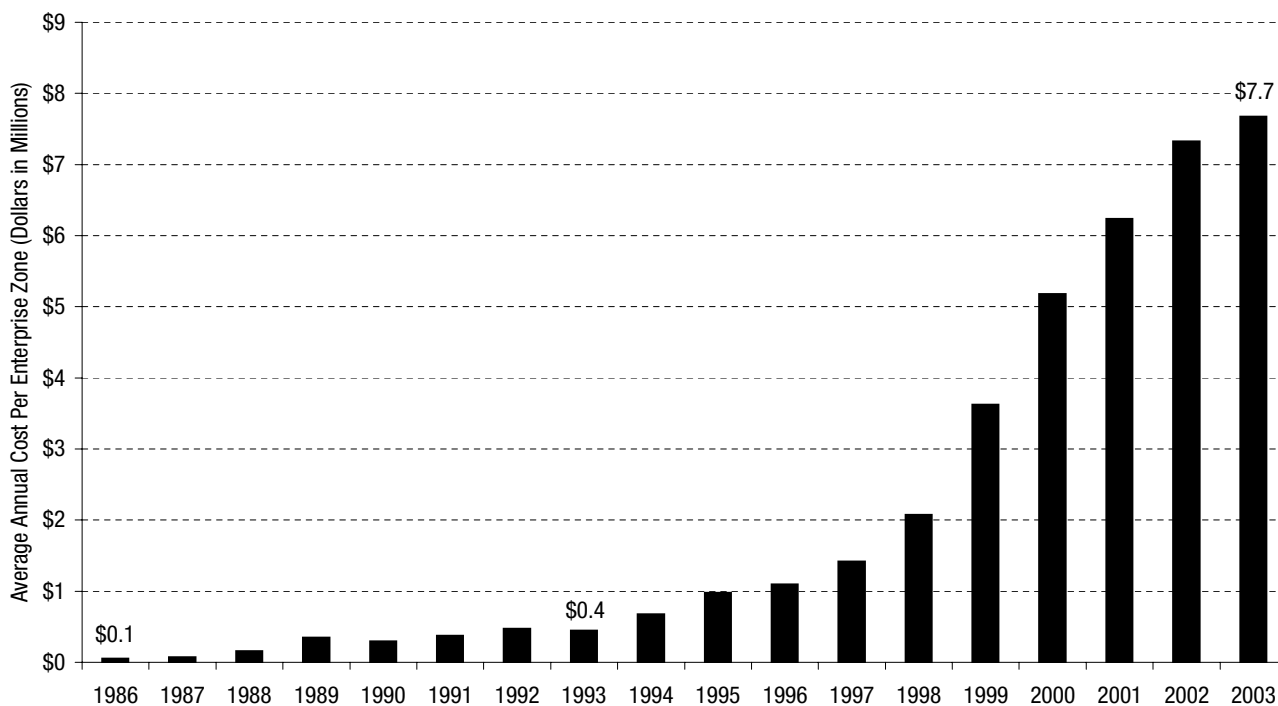
Corporations in the San Francisco Bay Area and Los Angeles zones claim a high proportion of zone tax breaks (Figure 3). In 2003, tax credit usage was highest in the San Francisco zone, which cost the state \$14.0 million, 10.2 percent of all EZ credits claimed by corporations in the state. Each of Los Angeles' five

Figure 1: Cost of Enterprise Zones Has Skyrocketed



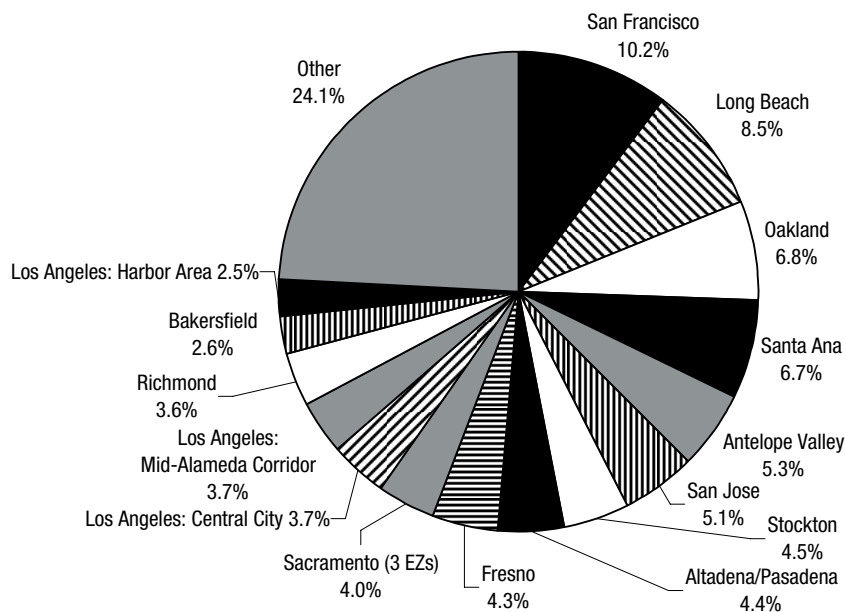
Source: Franchise Tax Board

Figure 2: Cost Per Zone Has Increased Substantially



Source: Franchise Tax Board

Figure 3: EZ Credit Usage Was Highest in San Francisco, 2003



Note: Other includes two zones in Los Angeles. Data exclude credits for companies that file personal income tax returns and companies in multiple zones or with unknown locations.
Source: Franchise Tax Board

EZs cost the state between \$2.3 million and \$5.1 million in tax credits in 2003 (Appendix B). Corporations located within Long Beach, Oakland, Santa Ana, Antelope Valley, and San Jose EZs also claimed substantial tax breaks. In contrast, EZs in Calexico, Delano, and Shafter, which are in rural areas with very high unemployment rates, cost less than \$1 million each.

Large Corporations Claim Most EZ Tax Breaks

The state's largest corporations receive most EZ tax breaks.⁷ In 2003, corporations with assets of \$100 million or more claimed 80.9 percent of all EZ credits claimed by corporations (Figure 4). Almost all of the tax credits (91.5 percent) were claimed by corporations with assets of \$10 million or more. Corporations with less than \$1 million in assets claimed only 1.4 percent of EZ credits. Thus, small businesses are not a major beneficiary of EZ tax breaks.

Trade and service corporations are heavy users of EZ credits. Retail and wholesale trade corporations claimed just over one-quarter (25.9 percent) of zone tax credits in 2003 (Figure 5). Service corporations claimed 32.1 percent of the credits (19.6 percent for financial services and 12.5 percent for other services). Manufacturing corporations claimed less than one out of every four dollars (23.7 percent) spent on EZ tax credits.

Recommendation: Substantially Reduce the Number of Zones.

The current program fails to direct benefits to distressed communities. Reducing the number of zones will help target the program to the most severely distressed areas.

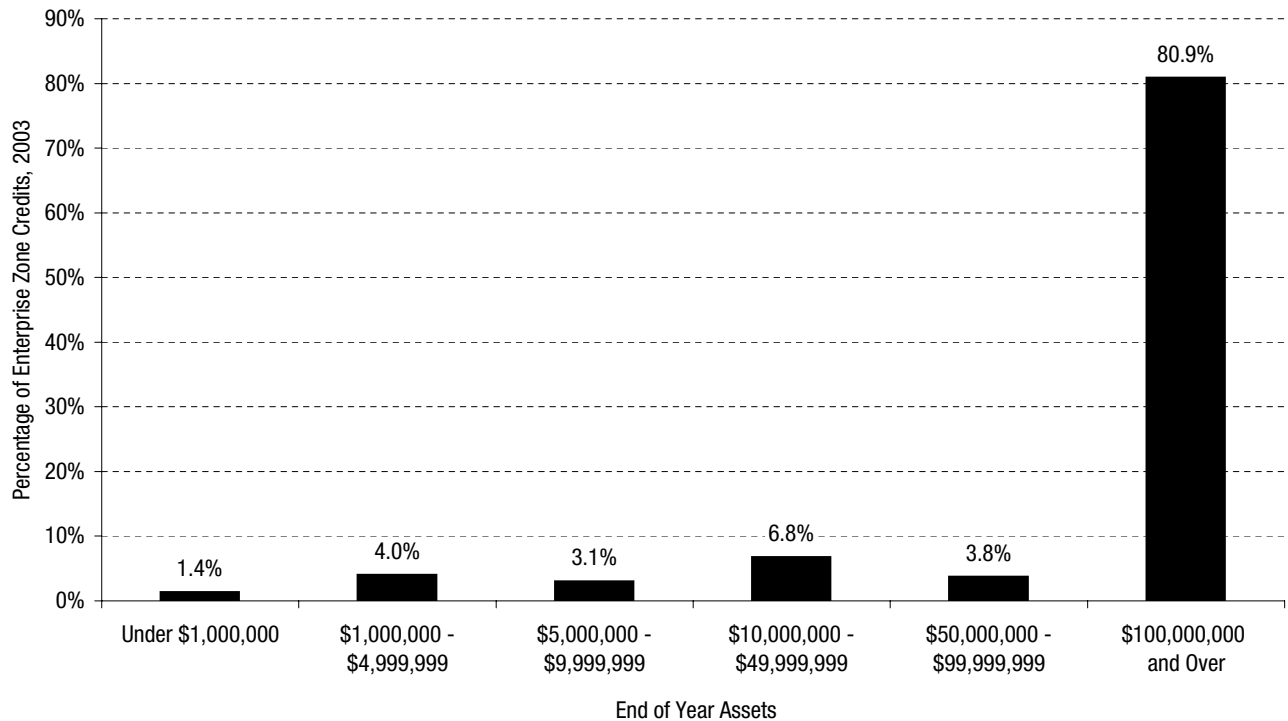
Recommendation: Reassess Zones Every Five Years and Terminate Zones That Are No Longer Economically Distressed.

Zones should receive an initial designation of five years. After the initial designation period, zones that continue to meet designation criteria should be extended for five years, for a total period of 10 years. Zones that no longer meet eligibility criteria after the initial five-year period should be terminated.

Local Governments Have No Incentive to Control Program Costs

Local governments approve the forms businesses need to claim EZ hiring tax credits, the most significant EZ tax break. However, local governments pay no portion of the costs of tax credits and thus have no incentive to ensure that credits are claimed only for qualified workers.

Figure 4: Eighty Percent of EZ Tax Credits Go to Corporations with Assets of \$100 Million or More



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

Recommendation: Require Local Governments to Share in the Cost of EZ Tax Breaks.

If local governments paid a share of the cost of the hiring credit, they would be more likely to ensure that businesses claim the credit in accordance with state law and regulations.

Finding 3: The Enterprise Zone Hiring Tax Credit Rewards Businesses That Do Not Hire Workers with Barriers to Employment or Create New Jobs

The high cost of the EZ Program is primarily attributable to the hiring tax credit.⁸ In 2003, hiring credits cost the state \$275.8 million, 92.2 percent of the total cost of EZ tax breaks.

In order to claim the hiring tax credit, companies must receive an approved voucher for each employee for whom a credit is claimed from a local jurisdiction that oversees the administration of an EZ. Companies can receive credit vouchers from administrators of the zone in which they are located, or from a zone administrator in another part of the state.

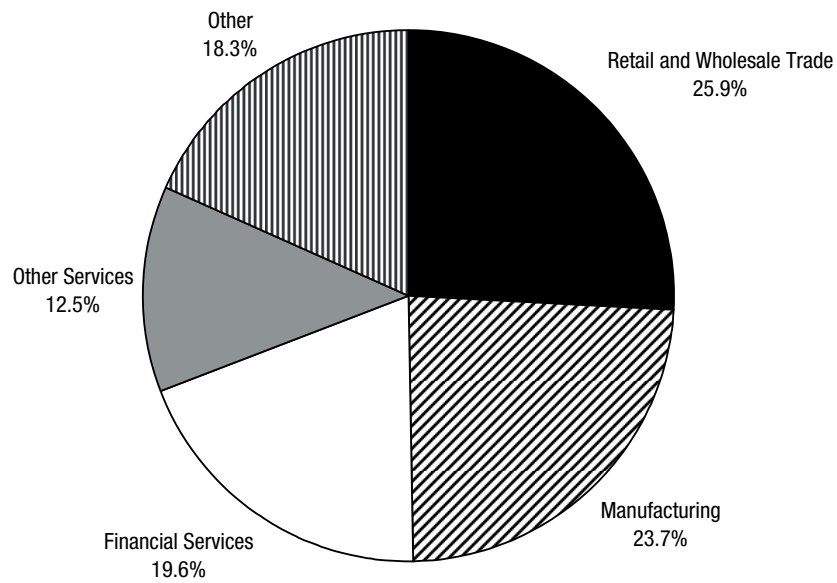
While EZ Program supporters claim that the program encourages employers to hire disadvantaged individuals, the overwhelming majority of approved credit vouchers are for employees who are not disadvantaged, but merely happen to live at the right address. In 2004, nearly two-thirds (64.8 percent) of hiring credit vouchers approved by EZs were for residents of Targeted Employment Areas (TEAs).⁹ However, EZ businesses may claim tax credits for any TEA resident, regardless of his or her income or other characteristics (Figure 6). The figure was higher for many zones. All vouchers approved by the Pittsburgh EZ in 2003 and 2004, for example, were for TEA residents. In contrast, only 2.7 percent of vouchers approved by EZs in 2004 were for employees who were participants in or eligible for income support programs.

Numerous flaws in the qualifying criteria prevent the hiring credit from targeting disadvantaged workers.

Businesses Can Claim Credits Based on TEA Residency, Not Disadvantage

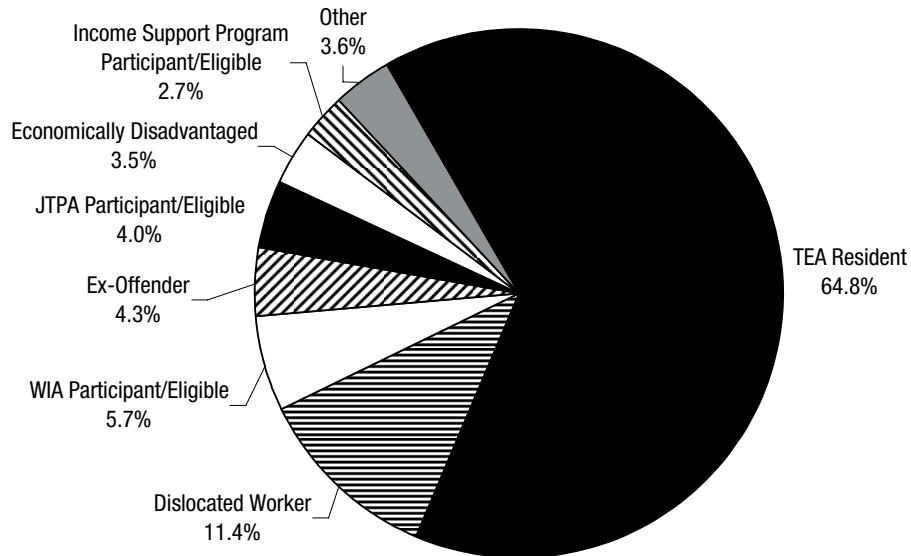
TEA residency allows employers to claim tax credits based solely on where a worker lives and not on any objective measure of whether that individual faces a barrier to employment. A TEA can include all or part of the zone itself, as well as additional areas that may or may not be adjacent to the zone. TEAs can only include census tracts in which more than half of residents have

Figure 5: Trade and Services Corporations Used Over Half of EZ Credits, 2003



Note: Other includes agriculture, construction, information, and transportation and utilities. Data exclude companies that file personal income tax returns.
Source: Franchise Tax Board

Figure 6: Nearly Two-Thirds of Hiring Credit Vouchers Were for TEA Residents, 2004



Approved Hiring Credits by Eligibility Category

Note: TEA = Targeted Employment Area; WIA = Workforce Investment Act; JTPA = Job Training Partnership Act (repealed in 2000).
Income support programs include CalWORKs, Supplemental Security Income, food stamps, and General Assistance.
Data exclude vouchers for eight zones that did not report hiring credit data by category.
Source: Department of Housing and Community Development

low incomes, defined as those who have incomes at or less than 80 percent of the area median.¹⁰ 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 had incomes of \$80,000 or less.

In addition, TEA boundaries do not need to be updated, even if robust economic growth has occurred and parts of the TEA are no longer economically distressed. If part of a TEA becomes an economically thriving area and a company in an EZ hires a manager who lives in the TEA, the company can claim a tax credit for hiring the manager. For example, San Francisco's TEA includes two census tracts in the Castro district, a neighborhood that once had lower incomes than the city as a whole, but is now economically prosperous. Because these tracts are in San Francisco's TEA, companies located in the EZ can claim credits for hiring anyone who lives there.

Recommendation: Eliminate Targeted Employment Area Residency as a Criterion for Hiring Credit Eligibility.

Eligibility for hiring credits should be based on whether a worker faces a barrier to employment, not where he or she lives. Employers can claim hiring credits for TEA residents who are truly disadvantaged as documented by qualification under other eligibility categories.

Some Hiring Credit Eligibility Categories Are Not Restricted to Disadvantaged Workers

Most of the categories used to determine eligibility for hiring credits are directed at workers facing barriers to employment, such as lack of job skills, low incomes, or criminal records. However, some categories allow workers who do not fit these categories to qualify an employer for a hiring credit.

For example, 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. Under the JTPA "10 percent exception," local administrators could enroll otherwise ineligible individuals into JTPA, up to a maximum of 10 percent of total enrollees. EZs have used this loophole to approve vouchers precisely because the employees did not meet JTPA eligibility criteria. Moreover, the JTPA program expired in 2000, yet EZs continue to use JTPA eligibility criteria and this loophole in the former program to approve vouchers.

How Do Firms Use the Hiring Tax Credit?

Companies can claim credits for wages paid to certain individuals, up to 150 percent of the state's minimum wage (currently \$10.12 per hour). Aircraft manufacturers located in the Long Beach EZ can claim credits for wages up to 202 percent of the minimum wage (\$13.63 per hour). Companies can claim credits for employees who are paid more, but the maximum credit does not increase. The value of the tax credit per individual hired is 50 percent of wages paid in the first year employees are hired; 40 percent in the second year after hire; 30 percent in the third; 20 percent in the fourth; and 10 percent in the fifth.

Companies can claim hiring tax credits for workers who, at the time of hiring, are:

- eligible for specified job training programs,
- eligible for certain income support or similar programs,
- economically disadvantaged,
- qualified dislocated workers,
- certain persons with disabilities,
- certain veterans,
- ex-offenders,
- members of a federally recognized Indian tribe,
- residents of a Targeted Employment Area (TEA), or
- residents of federally designated empowerment zones, enterprise communities, or renewal communities.

An audit of the Oakland EZ identified many questionable practices regarding the issuance of hiring credit vouchers.¹¹ The zone incorrectly approved 13 percent of the vouchers examined by using the "10 percent exception" rule, approving vouchers for employees who did not meet JTPA eligibility criteria. The audited vouchers were approved between January 2001 and September 2003, well after expiration of the JTPA program.

Other EZs have also approved vouchers using the "10 percent exception" rule. More than half of the vouchers that the Yuba/Sutter EZ approved in 2003 were for employees qualified under the "10 percent exception." Three EZs used the JTPA "10 percent exception" in 2004, the most recent year for which voucher data are available.¹²

Other hiring credit eligibility categories are not linked to an individual's barriers to employment. The Workforce Investment Act (WIA), which replaced the JTPA program in 2000, places a high priority on "universal access" and thus a lower priority on targeting services for disadvantaged persons. In fact, all adults are eligible to receive WIA "core" services, such as skill assessment and job placement assistance. Enrollment priority for more intensive WIA services, such as training and case management, must be given to public assistance recipients and other low-income persons. However, if WIA funds are not limited in a local area, others may also receive these "intensive" services.¹³ Thus, individuals without barriers to employment can be eligible for intensive services.

Similarly, employers can claim credits for workers who leave companies that have announced a layoff, even if a specific worker has not lost or is not in danger of losing his or her job.

For example, assume a company announces it will eliminate a division in order to boost its profits. A zone business that hires a valued worker from the company that announced the layoff can claim a tax credit, even if that worker's division is not affected by the layoff and his or her position is not in jeopardy.

Recommendation: Eliminate Hiring Credit Eligibility Categories That Are Not Linked to Barriers to Employment.

Eligibility for hiring credits should be limited to individuals with specific barriers to employment. Employers should be excluded from claiming hiring credits for tribal members and veterans who are not individually disadvantaged. Similarly, employers should be excluded from claiming credits for individuals who work for an employer that has announced a potential layoff, but where the individual in question has not lost or will not lose his or her job.

Are EZs Effective?

The research and evaluation literature provides no conclusive evidence that EZ tax breaks are effective. One national study finds that "enterprise zones have not been successful" and "are not effective engines of economic expansion," despite the authors' expectation that they would find the reverse.¹⁴ In particular, the authors find that zones have "little or no impact" on firm or employment growth.¹⁵ Similarly, evaluations of California's program have not provided strong evidence that the EZ tax breaks are successful. All of the studies of the state's EZ Program share a common flaw: no data are available that distinguish between businesses that use EZ tax breaks and those that do not.

- A California Research Bureau (CRB) study published in August 2001 found that the average EZ had substantially higher job growth rates and higher rates of firms locating within their borders, as compared to similar areas.¹⁶ However, the study design did not enable the authors to conclude that the tax breaks themselves caused stronger growth because the study did not link higher job growth to businesses' use of tax breaks. Other program components, such as local economic development assistance, could be partly or fully responsible for any increased employment. In addition, the success of individual zones varied considerably despite uniform state tax breaks: of the 24 areas studied, seven had lower job growth rates and eight had lower growth rates in the number of new firms locating to the area, as compared to their non-zone matches.¹⁷ Moreover, the CRB study found that higher job growth in EZs was short-lived. For example, EZs designated prior to 1990 did not have higher job growth between 1995 and 1999 than matched areas.
- An analysis of California's EZ Program, performed for the enterprise zone trade association and based on the findings of the CRB study, found the program to have a net benefit to the state; however, this analysis has the same drawbacks as the CRB study since it does not examine whether job growth occurred in firms that claimed the program's tax breaks.¹⁸ In addition, the analysis did not estimate the impact of state revenues lost due to EZ tax breaks on other state programs, services, and employment.
- A 1994 evaluation of California's EZs found that 85 percent of the zones included in the analysis had lower employment growth than predicted. In the study's survey of zone area businesses, nearly all respondents reported that the benefits of the EZ Program had not influenced their business decisions. "Those that had relocated into or expanded within a zone or area were nearly unanimous" that their business had not located where it had because of any program benefits, and most businesses using the hiring credit reported that the credit did not influence whom they hired.¹⁹
- In 1995, the California State Auditor was unable to determine the effectiveness of EZs for a variety of reasons, including a lack of data and the fact that it could not isolate the effects of EZ programs from other factors influencing the regions' economies.²⁰ Both the Auditor and the 1994 evaluation called for more extensive and reliable data collection so that the effectiveness of EZs could be more accurately reviewed.

Recommendation: Allow Businesses to Claim Hiring Credits for Workforce Investment Act (WIA) Participants Only if They Are Low-Income Participants in WIA Intensive Services.

Only WIA enrollees who are recipients of public assistance or have low incomes should qualify their employers for a hiring credit. Otherwise, any adult could qualify their employer for a hiring credit because all adults are eligible to receive core services, and individuals enrolled in intensive services do not need to have low incomes if funds are not limited in a local area.

The Hiring Credit Does Not Require Creation of New Jobs

Companies can claim hiring credits without creating new jobs, since the credits are for new hires, not new jobs. For example, if a company moves into an EZ and hires 10 employees who qualify for a hiring credit, the company could claim credits for creating 10 new jobs. If the workers remain in the jobs, the company could claim the credits for five years. However, if a business that was in the EZ prior to designation loses 10 workers due to normal turnover and then fills those positions with qualified employees, it could also claim credits, even though it created no new jobs. To the extent that workers left and the company refilled positions, it could perpetually claim new credits for new hires over the lifetime of the EZ. Thus, the hiring credit rewards companies that create no new jobs, but have high turnover rates, more than it rewards companies that create steady employment. 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.²¹

Recommendation: Require Businesses to Increase Employment as a Condition of Claiming Hiring Credits.

Hiring credits should encourage companies to create new jobs, not refill existing positions.

Recommendation: Change the Hiring Credit Formula to Discourage Job Turnover.

The Legislature should modify the hiring credit formula using a revenue-neutral approach so that the credit a company claims for an individual worker has the same maximum value for a five-year period. Maintaining the maximum value of the credit at the same percentage of the minimum wage in each year could discourage churning.

Hiring Credit Worksite Location Requirement Is Overly Broad

Companies may claim hiring credits for employees who perform as little as half of their work in an EZ. In addition, current voucher

applications do not require employers to document workers' location of employment.

Recommendation: Require Proof That an Employee Performs at Least Half of His or Her Work in an EZ in Order for a Business to Claim a Hiring Credit for That Employee.

Companies should demonstrate that employees for whom they claim hiring credits work the required amount of time in the zone. Employers should declare under penalty of perjury that all information provided in a voucher application is correct. Quarterly payroll tax withholding records should not be allowed as proof of an employee's work location, since employers are not required to submit a separate quarterly withholding report for each location at which they do business.

Recommendation: Adjust the Value of the Hiring Credit Based on the Amount of Work an Employee Performs in an EZ.

The value of the credit should be based on the percentage of time that an employee works in the EZ. For example, a business would be able to claim 60 percent of the credit otherwise available if an employee works 60 percent of his or her hours in the zone.

Finding 4: The Enterprise Zone Hiring Credit Is Prone to Abuse

Companies Shop for Vouchers

Companies typically receive credit vouchers from administrators of the zone in which they are located. However, state law allows companies to seek vouchers from other EZs; for example, a company located in the Stockton EZ can apply for a voucher from the Eureka zone. Companies and their consultants have an incentive to "shop" for zone administrators who are most willing to approve vouchers. Local jurisdictions responsible for issuing vouchers may charge companies a voucher application fee, creating an incentive for a zone to increase the number of vouchers issued.

An audit of the Oakland EZ found that at least 61 percent of hiring vouchers issued between January 2001 and September 2003 were for companies located outside the Oakland EZ.²² The audit found that Oakland issued many vouchers to firms in other EZs based on TEA addresses whose validity auditors could not confirm.²³ The Oakland EZ approved voucher applications previously rejected by at least one other EZ.

Recommendation: Allow EZ Administrators to Approve Hiring Credit Vouchers Only for Businesses Located Within Their Zone.

The Legislature should prohibit “cross-zone” vouchering. Zones should be limited to issuing vouchers to firms within their boundaries. This report’s previous recommendation that local governments share in the cost of zone incentives should be structured to require the jurisdiction approving a voucher to pay a share of the tax credits associated with that voucher.²⁴

Retroactive Credits Provide Rewards, Not Incentives

Current law allows companies to claim hiring tax credits long after an individual begins work and even for workers who are no longer employed at a zone business. Consultants have marketed their ability to lower companies’ tax liabilities by claiming these credits on amended tax returns. Over 4,000 returns were amended for tax years 1999 through 2003, reducing state revenues by \$169.3 million (Table 1). EZ tax credits claimed on amended returns accounted for 14.5 percent of the cost of total EZ tax breaks claimed between 1999 and 2003. In addition, the audit of the Oakland EZ found that, of vouchers issued to companies in other EZs, 97 percent were issued more than six months after employees were hired.²⁵ By definition, retroactive credits provide bonuses for past actions, but do not encourage businesses to increase or maintain employment in future years and thus do not further program goals. The Legislative Analyst’s Office notes that providing credits retroactively “provides more of a reward than an incentive.”²⁶

Recommendation: Eliminate the Ability of Businesses to Claim Retroactive Hiring Credits.

Retroactive hiring credits cause the state to lose tax revenues without providing an incentive to hire disadvantaged individuals.

Table 1: EZ Tax Credits Claimed on Amended Corporate Tax Returns

Tax Year	Number of Amended Returns	Tax Credits (Dollars in Millions)	Tax Credits on Amended Returns as a Percentage of the Cost of EZ Tax Breaks
1999	988	\$29.5	20.9%
2000	1,109	\$44.2	21.9%
2001	1,021	\$37.5	15.4%
2002	752	\$40.3	14.1%
2003	371	\$17.8	5.9%
Total, 1999-2003	4,241	\$169.3	14.5%

Source: Franchise Tax Board

The Hiring Credit Voucher Approval Process Is Error-Prone

The hiring credit criteria refer to numerous programs with differing eligibility guidelines. County human service departments, for example, employ eligibility workers whose sole purpose is to determine eligibility for many of these programs because of program guidelines’ complexity. Workers processing EZ hiring credit applications who are not trained to make such determinations may erroneously certify individuals’ eligibility for hiring credits. The Oakland EZ audit noted that the zone was unable to perform basic functions, such as verifying whether workers met qualifying criteria and maintaining adequate records associated with voucher approvals.²⁷

Recommendation: Allow Businesses to Claim a Hiring Credit Based on a Worker’s Eligibility for an Income Support Program Only if the Agency or Department Responsible for the Program Certifies the Worker’s Eligibility.

The department or agency that determines eligibility for income support and similar programs, not EZ workers, should verify eligibility status for these programs. Similarly, eligibility for hiring credits based on WIA criteria should be certified by the agency responsible for local WIA program administration.

Recommendation: Terminate the Designation of Zones That Willfully Abuse Program Rules.

The Department of Housing and Community Development should establish quality control standards regarding issuance of hiring credit vouchers. Zones that do not meet or are found to willfully disregard these standards should be terminated immediately.

Terminology Is Vague

Many terms used in the hiring credit qualification criteria are vague or not defined. For example, some EZ administrators have interpreted “ex-offender” as an individual who has committed any type of infraction, including a traffic violation.

Recommendation: Clearly Define the Types of Workers Who Qualify Businesses for Hiring Credits and Delete References to Obsolete Programs.

Clearly defined terminology will help ensure that employers claim credits only for qualified workers.

Finding 5: Enterprise Zone Eligibility Criteria Are Overly Broad

Potential EZs can compete for zone designation if they meet baseline criteria demonstrating economic distress.²⁸ 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 allows potential EZs to meet either of two sets of criteria, identified below as Methods 1 and 2 (Table 2). Under Method 1, prospective EZs must satisfy any one of the following criteria: one or more plant closures affecting more than 100 workers within the past two years; having "a history of gang-related activity," whether or not violent crimes have actually been committed; or meeting the economic distress criteria of the now-defunct federal Urban Development Action Grants. Under Method 2, the proposed EZ must have at least two of the following characteristics:

- each census tract must have an unemployment rate that is at least 3 percentage points above the statewide average;
- each census tract must have a median household income for family of four that is at or below 80 percent of the state median; or
- the city or county in which the zone is located must have a free school lunch participation rate of at least 70 percent.

Table 2: How Areas Can Qualify as EZs

Method 1 (one of the following)	Method 2 (two of the following)
Plant closures	High unemployment rate
Gang-related activity	Low median income
Economically distressed per obsolete federal grant program definition	High free school lunch rate

Local governments are not required to demonstrate how EZs fit into broader local economic development strategies and state law does not require local governments applying for zone designation to have a comprehensive economic development strategy.

Once designated, EZs can expand their geographic boundaries by 15 percent (20 percent for EZs measuring 13 square miles or less). State law does not require EZs to substantiate economic distress to retain their original 15-year designation, to receive a five-year extension, or to expand.

Recommendation: Restrict Zone Designation to the Most Economically Distressed Communities.

The Legislature should define a single set of eligibility criteria that are easily measurable and reflect the extent and persistence of the economic distress of proposed zones. Specifically, each census tract within a proposed zone should meet at least two of the following criteria:

- unemployment rates that are substantially and persistently higher than the statewide average;
- median incomes that are substantially and persistently lower than the statewide levels; and
- poverty rates that are substantially and persistently higher than the statewide average.

Current criteria that do not adequately measure an area's overall economic well-being should be rejected. Specifically, references to obsolete programs, plant closures, and gang activity should be deleted. In addition, participation in the federal free lunch program should be excluded as a criterion because eligibility for program participation is difficult to measure and can reflect schools' success in enrolling children in the program, rather than actual need. Moreover, county participation rates may not reflect conditions within a particular zone, particularly in large urban counties.

Recommendation: Prioritize Zone Designation for Areas with Strong Economic Development Strategies.

EZ tax breaks are more likely to be effective if they are an integral component of a coherent development strategy. Local governments applying for zone designation should be required to outline a comprehensive economic development strategy and the EZ's role as part of that strategy.

Recommendation: Allow Zones to Expand Only into Adjacent Areas That Are Economically Distressed.

Expansion should be limited to adjacent areas that would qualify as economically distressed using the criteria established for zone designation.

Regulations Are Not Aligned with Statutory Eligibility Criteria

Existing regulations that implement Method 2 eligibility criteria vary substantially from state laws establishing the EZ Program and benefits. First, regulations do not require all areas of an EZ to be economically distressed. The current regulations allow EZs to include areas that are primarily commercial or industrial, even if these areas are not economically distressed. In addition, regulations broaden the definition of a distressed area and require

A Case Study: San Francisco EZ Does Not Meet Economic Distress Standard

The San Francisco Enterprise Zone accounts for the largest usage of tax breaks among the state's 42 zones and includes some of the most valuable real estate in the state.²⁹ The San Francisco EZ was designated in 1992 and covers a large variety of neighborhoods: Chinatown, Union Square, Nob Hill, Hayes Valley, Civic Center, Haight-Ashbury, the Mission, South of Market, Potrero Hill, Bayview, and Hunters Point. Many of these neighborhoods were transformed by the high-tech boom and are not economically distressed. In fact, few census tracts would likely qualify as part of an EZ using 2000 Census data (Table 3).³⁰ Of the 57 census tracts in the EZ:

- Only 17 met at least two economic distress criteria as required for EZ eligibility.
- Seventeen had median household incomes greater than San Francisco's median of \$55,000, including three census tracts in Potrero Hill with median household incomes that exceeded \$75,000 in 1999.
- Eighteen tracts had unemployment rates below the city average of 4.6 percent and 11 had rates below 3.0 percent.
- Fourteen had poverty rates below the city rate of 11.3 percent.
- Twenty-two tracts had a higher share of college graduates in 2000 than did San Francisco as a whole.³¹

The San Francisco zone includes Potrero Hill, now a desirable residential area (Table 4).

The San Francisco EZ has a Targeted Employment Area (TEA) that includes 11 census tracts that are not part of the EZ, which includes parts of the Castro district, where the median home price was \$902,500 in December 2005, and includes four census tracts that do not meet the low-income requirement.³²

Which Businesses Claim Tax Breaks in San Francisco?

Businesses located in the EZ and eligible to use the tax breaks include:³³

- Several dozen high-end hotels, including both historic and boutique hotels, most of which are located in the Union Square and Nob Hill areas (Table 5). Some hotels, including the Argent and the Four Seasons, were not in the original EZ but were added when the state approved an expansion of the EZ in 1993. This expansion included only parts of several census tracts, raising questions as to whether the expansion was designed to include particular businesses.
- A number of shopping centers and retail shops. These include the Metreon and the San Francisco Shopping Centre on Market Street near Union Square Hill, which predates the EZ designation and includes Nordstrom, Abercrombie and Fitch, and Coach.
- The San Francisco Design Center and the Gift Center and Jewelry Mart, both in the South of Market district.

Table 3: San Francisco EZ Census Tracts Meeting Economic Disadvantage Criteria

Number of Criteria Met	Number of Census Tracts
Met No Criteria	18
Met at Least One Criterion	39
Met at Least Two Criteria	17
Met Three Criteria	4
Total Census Tracts in Enterprise Zone	57

Note: Child poverty measure is used to approximate free school lunch receipt in census tract. Income eligibility for free school lunch program is 130 percent of federal poverty level. Income and poverty data are for 1999; unemployment data are for 2000. Source: CBP analysis of 2000 Census data

Table 4: Profile of EZ Census Tract in Potrero Hill

Median Household Income	\$95,000
Median Price of House	\$615,000
Unemployment Rate	5.3 percent
Poverty Rate	1.2 percent
Adults with Bachelor's Degree or Higher	70.0 percent
Adults Lacking a High School Degree	9.6 percent

Note: Income and poverty data are for 1999; unemployment and educational data are for 2000; median home price is for zip code 94107 in December 2005. Census Tract 227.02. Source: CBP analysis of 2000 Census data; real estate data from dataquick.com

Table 5: Selected Hotels Located in the San Francisco Enterprise Zone

Hotel	Added by 1993 EZ Expansion?	Hotel	Added by 1993 EZ Expansion?
Argent Hotel	Yes	InterContinental Mark Hopkins	
Adagio Hotel		Marriott Hotel	Yes
Biltmore Hotel		Maxwell Hotel	
Cartwright Hotel		Petite Auberge	
Commodore Hotel		San Francisco Hilton	
Four Seasons Hotel	Yes	Stanford Court	
Hotel Monaco		Warwick Regis Hotel	
Hotel Rex		Westin St. Francis	
Huntington Hotel			

Source: CBP analysis of business locations and enterprise zone street listings

potential zones to meet at least three of five criteria. Regulations require unemployment rates to be only about 1.5 percentage points higher than the statewide average, whereas state law requires EZ tracts to have unemployment rates that are at least three percentage points higher than the state average. The regulations also include two criteria, change in per capita income and poverty rate, that are not found in state law.

The final criterion outlined in program regulations is whether a potential EZ is located in a jurisdiction that has been declared a national disaster area at any point in the prior seven years. This criterion apparently derives from a section of the law instructing the administering state agency how to rate EZ applications, not the section describing EZ eligibility. Federal disaster area designation typically applies to an entire county or counties. Since 2000, over half of California's counties have been designated as federal disaster areas. Any census tract within counties recently declared disaster areas would meet this criterion even if the disaster had no economic impact on the tract in question.

Since regulations require potential zones to meet three eligibility criteria, census tracts could qualify as an EZ if they meet the unemployment, poverty, and disaster area criteria. For example, census tracts located in a county that has been declared a disaster area could qualify if they have unemployment and poverty rates that are modestly higher than those of the state as a whole, even if the disaster had no effect on the area seeking EZ designation and the conditions leading to the disaster declaration had long since been remedied.

Recommendation: Require EZ Program Regulations to Reflect Eligibility Requirements Contained in State Law.

Regulations should implement the program as defined in state law and not introduce different or weaker program requirements.

CONCLUSION

California's Enterprise Zone Program has cost the state over \$1.5 billion in lost tax revenues since its inception. However, numerous studies have failed to establish a link between EZ tax incentives and increased employment, firm growth, or economic development. In fact, such a link would be difficult, if not impossible to establish, due to the program's failure to gather even the minimal amount of data that would be needed for a credible evaluation of the effectiveness of EZ tax breaks.

Moreover, the EZ Program has expanded to the point where reports suggest that upwards of one out of every eight workers is employed within the boundaries of an EZ and zones encompass some of the state's most costly and desirable real estate. The size and scope of the current program undermines its underlying goal of targeting assistance to those areas of the state that are most severely distressed and thus most in need of assistance in order to attract jobs and businesses.

The criteria used to determine eligibility for EZ tax breaks have proven to be prone to abuse and rely on standards that provide sizeable rewards to businesses, which are not required to create new jobs or even hire workers that face barriers to employment. The loss of state tax dollars, in turn, limits the resources available to improve California's schools, address outstanding infrastructure needs, or meet other state priorities.

Policymakers should act immediately to ensure that tax dollars are spent responsibly and accountably to assist those communities most in need.

Appendix A: California's Enterprise Zones

Enterprise Zone	Expiration Date
Agua Mansa (Riverside/San Bernardino County)	10/14/2006
Altadena/Pasadena	4/09/2007
Antelope Valley	1/31/2012
Bakersfield	10/14/2006
Barstow	10/08/2020
Calexico	10/14/2006
Coachella Valley	11/10/2006
Delano	12/16/2006
Eureka	11/14/2006
Fresno	10/14/2006
Imperial Valley	11/06/2020
Kings County	6/21/2008
Lindsay	10/05/2010
Long Beach	01/07/2007
Los Angeles: Central City	10/14/2006
Los Angeles: Eastside	10/10/2008
Los Angeles: Harbor Area	3/03/2009
Los Angeles: Mid-Alameda Corridor	10/14/2006
Los Angeles: Northeast Valley	10/14/2006
Madera	3/04/2009
Merced/Atwater	12/16/2006
Oakland	9/27/2008
Oroville	11/05/2006
Pittsburg	1/10/2008
Porterville	10/14/2006
Richmond	3/01/2007
Sacramento: Army Depot	4/04/2009
Sacramento: Florin-Perkins	4/04/2009
Sacramento: Northgate/Norwood	10/14/2006
San Diego: San Ysidro/Otay Mesa	1/27/2007
San Diego: Southeast/Barrio Logan	10/14/2006
San Francisco	5/27/2007
San Jose	10/14/2006
Santa Ana	6/07/2008
Shafter	10/03/2010
Shasta Metro (Redding)	11/05/2006
Shasta Valley (Siskiyou County)	6/21/2008
Stanislaus	10/25/2020
Stockton	6/21/2008
Watsonville	4/30/2012
West Sacramento	1/10/2008
Yuba/Sutter	10/14/2006

Source: Assembly Jobs, Economic Development, and the Economy Committee

Appendix B: Cost of Tax Credits Used by Enterprise Zone, 2003

Enterprise Zone	Tax Credits Used
Agua Mansa (Riverside/San Bernardino County)	\$1,802,278
Altadena/Pasadena	\$6,084,011
Antelope Valley	\$7,191,471
Bakersfield	\$3,541,245
Barstow*	\$0
Calexico	\$930,167
Coachella Valley	\$1,778,038
Delano	\$147,986
Eureka	\$1,385,223
Fresno	\$5,921,275
Imperial Valley*	\$0
Kings County	\$3,120,953
Lindsay	\$235,510
Long Beach	\$11,681,326
Los Angeles: Central City	\$5,123,062
Los Angeles: Eastside	\$2,614,975
Los Angeles: Harbor Area	\$3,470,799
Los Angeles: Mid-Alameda Corridor	\$5,014,816
Los Angeles: Northeast Valley	\$2,256,805
Madera	\$2,300,612
Merced/Atwater	\$3,302,721
Oakland	\$9,243,550
Oroville	\$978,413
Pittsburg	\$641,543
Porterville	\$741,581
Richmond	\$4,898,582
Sacramento: Army Depot	\$995,665
Sacramento: Florin-Perkins	\$4,040,368
Sacramento: Northgate/Norwood	\$391,401
San Diego: San Ysidro/Otay Mesa	\$1,584,697
San Diego: Southeast/Barrio Logan	\$1,041,231
San Francisco	\$13,993,170
San Jose	\$6,925,850
Santa Ana	\$9,108,461
Shafter	\$72,181
Shasta Metro (Redding)	\$1,788,002
Shasta Valley (Siskiyou County)	\$319,228
Stanislaus*	\$0
Stockton	\$6,174,697
Watsonville	\$1,278,612
West Sacramento	\$1,662,605
Yuba/Sutter	\$3,063,074
Total	\$136,846,184

* Designated in 2005.

Note: Includes hiring tax credit and sales and use tax credit. Data exclude credits for companies that file personal income tax returns and companies in multiple zones or with unknown locations.

Source: Franchise Tax Board

ENDNOTES

- ¹ AB 2798 (Machado, Chapter 323 of 1998).
- ² The Los Angeles Revitalization Zone, created following the civil unrest of 1992, expired in 1998.
- ³ 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. The amounts include tax breaks claimed on originally filed returns as well as amended returns.
- ⁴ Franchise Tax Board (FTB), as cited in an FTB memorandum to Assemblymember Johan Klehs (November 22, 2005).
- ⁵ See, for example, Timothy J. Bartik, Who Benefits from State and Local Economic Development Policies? (Kalamazoo, MI: W.E. Upjohn Institute for Employment Research, 1991), p. 207.
- ⁶ Ted K. Bradshaw, Ph.D., Cost-Benefit Analysis of California's Enterprise Zone Program, prepared for California Association of Enterprise Zones (June 5, 2003), p. 34.
- ⁷ FTB data cited in this section only include businesses that file corporate income tax returns; the data exclude businesses that file personal income returns, although these businesses qualify for the same tax breaks.
- ⁸ The 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 (March 21, 2006).
- ⁹ A TEA is an area identified by the local jurisdiction that has relatively low incomes.
- ¹⁰ Government Code, Section 7072(h). State law requires that at least 51 percent of the residents of a TEA census tract have "low- or moderate-income levels," which the US Department of Housing and Urban Development defines as less than 80 percent of the area median.
- ¹¹ Franchise Tax Board memorandum on Oakland Enterprise Zone Vouchering Audit (November 17, 2003). This report draws heavily on the audit of the Oakland EZ program since the audit provides uniquely detailed information. However, the practices described in the audit of the Oakland zone may or may not be typical of those in other zones.
- ¹² Department of Housing and Community Development data.
- ¹³ In order to receive intensive services, individuals must be unemployed and unable to obtain jobs through core services, or employed, but in need of additional services.
- ¹⁴ Alan H. Peters and Peter S. Fisher, State Enterprise Zone Programs: Have They Worked? (Kalamazoo, MI: W.E. Upjohn Institute for Employment Research, 2003), pp. 190 and 237.
- ¹⁵ Alan H. Peters and Peter S. Fisher, State Enterprise Zone Programs: Have They Worked? (Kalamazoo, MI: W.E. Upjohn Institute for Employment Research, 2003), p. 225.
- ¹⁶ The study identified areas that were near EZs and had comparable economic and demographic characteristics. Suzanne O'Keefe and Roger Dunstan, Evaluation of California's Enterprise Zones (California Research Bureau: August 2001).
- ¹⁷ In addition, growth rates in some EZs were so much higher than their matched areas that the difference could not be reasonably related to existence of EZs alone. For example, the job growth rate in the West Sacramento EZ was 445 percentage points higher than that of its matched area.
- ¹⁸ Ted K. Bradshaw, Ph.D., Cost-Benefit Analysis of California's Enterprise Zone Program, prepared for California Association of Enterprise Zones (June 5, 2003).
- ¹⁹ David E. Dowall, et al., Evaluation of California's Enterprise Zone and Employment and Economic Incentive Programs (California Policy Seminar: March 1994).
- ²⁰ California State Auditor, Bureau of State Audits, Trade and Commerce Agency: The Effectiveness of the Employment and Economic Incentive and Enterprise Zone Programs Cannot Be Determined (November 1995).
- ²¹ The maximum value of the hiring credit under the current formula begins at 50 percent of 150 percent of the minimum wage and then declines for each additional year a worker remains at a company. Companies can claim hiring credits for individual workers for up to a maximum of five years.
- ²² The Oakland EZ is the only zone for which out-of-area voucher data are available. Franchise Tax Board memorandum on Oakland Enterprise Zone Vouchering Audit (November 17, 2003).
- ²³ Franchise Tax Board memorandum on Oakland Enterprise Zone Vouchering Audit (November 17, 2003).
- ²⁴ The Department of Housing and Community Development (HCD) has issued draft regulations that would limit the issuance of vouchers to businesses in other EZs. In addition, the HCD released guidance on March 14, 2006, to enterprise zone managers directing them to cease approval of cross-zone vouchers.
- ²⁵ Franchise Tax Board memorandum on Oakland Enterprise Zone Vouchering Audit (November 17, 2003).
- ²⁶ Legislative Analyst's Office, California's Enterprise Zone Program (December 5, 2005).
- ²⁷ Franchise Tax Board memorandum on Oakland Enterprise Zone Vouchering Audit (November 17, 2003).
- ²⁸ Local governments apply to the Department of Housing and Community Development to establish an EZ. They previously applied to the Technology, Trade, and Commerce Agency, which was abolished in the 2003-04 Budget Act.
- ²⁹ However, the EZ as a whole is somewhat less prosperous than the city as a whole. For example, the zone had a higher unemployment rate (6.3 percent) in 2000 than did the remainder of San Francisco (3.9 percent) and a higher poverty rate (17.7 percent) in 1999 than the rest of San Francisco (8.5 percent).
- ³⁰ Based on Method 2 described in Table 2, applied by census tract. The CBP identified census tracts in the EZ based on a simplified enterprise zone map and street listings. San Francisco has 175 census tracts.
- ³¹ Education levels are for adults age 25 and older.
- ³² US Department of Housing and Urban Development data. State law requires that 51 percent of residents in TEA census tracts have "low- or moderate-income levels."
- ³³ Tax data do not allow identification of individual businesses in EZs that claim tax breaks.

