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CASE DISCUSSION 4:

ZONE-BASED TAX INCENTIVES AND LOCAL ECONOMIC REDEVELOPMENT

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Introduction

The loss of low skilled manufacturing jobs throughout the 1980's and 1990's has left many cities, especially those in the Great Lakes region, with soaring unemployment and urban poverty rates. Detroit, Michigan in particular has seen the number of workers in the manufacturing sector fall by more than half since 1980. The loss of manufacturing jobs is part of a larger decline in employment as Detroit has seen the number of residents who have a job fall by more than 16 percent since 1980, and the percentage of residents living in poverty rise by 25 percent over the same time period.

Tax incentives targeted to employers based on their location in blighted urban areas have been used by some states (California, New Jersey, and Indiana) with the intent to combat the loss of jobs and rising poverty. Among other tax breaks, these states offer a tax credit, which works like a voucher that offsets tax liability at the end of the year, for businesses that employ residents or hire new residents who live in a blighted urban area. More recently several states have enacted tax incentives based on a

[1] This case was written by Andrew Hanson, who is a graduate student in the Economics Department at Syracuse University, with some editorial suggestions from Professor Yinger. It was prepared solely for the purposes of class discussion.

“Zone” concept. The Zone concept defines an area of the city, usually a blighted area that is about 10 percent of the total city land area, and offers tax credits to businesses that locate in the Zone and comply with the employment requirements.

The specific rules of these tax credits are different for each state, but they have in common the Zone concept the business receiving the tax credit to a specific area of a distressed city. The State of Michigan is considering implementing a zone-based tax incentive program in Detroit modeled after the federal “Empowerment Zone” or EZ program, which has been in place since the mid 1990’s. In fact, one federal EZ covers part of Detroit, but state policy makers are looking into the possibility of adding state tax breaks to that zone and/or to other parts of the city. Policy makers in Michigan may eventually consider zone-based tax incentives in other cities, but at this point there is widespread agreement that Detroit, which is widely seen as the engine of the Michigan economy, needs help first.

Description of the Federal Program

The federal EZ program began offering tax incentives to businesses operating in blighted urban areas beginning in 1995. The original program established 6 urban zones, and Congress has established 29 new Empowerment Zones since 1997. President Bush’s 2007 budget also calls for a new zone-based tax-incentive program called “Opportunity Zones,” which, if passed, would create 20 new zones around the country.

Nominations for the Empowerment Zone program were considered for areas where at least 20 percent of the population was living in poverty and at least 6.3 percent were unemployed. From 78 urban nominees, parts of six cities (Atlanta, Baltimore, Chicago, Detroit, Philadelphia, and New York) were awarded EZ status by the U.S. Department of Housing and Urban Development (HUD). The original designation was given for a ten-year time period, but was later extended through the end of 2009.

The EZ program is meant to give a comprehensive package of assistance to an area, with the main component being tax incentives claimed by employers. The major tax incentives associated with an EZ are as follows [2]

179 Expensing: This provision allows businesses operating within the EZ to immediately expense the purchase of qualified property, instead of gradually depreciating the property over time. This step is allowed for most businesses that earn at least 50 percent of their gross income from the sale of products or services produced within the EZ and have at least 35 percent of their workforce living in the EZ. Most property is qualified as long as it was purchased after the EZ designation and is primarily used in the EZ. The regular 179 expensing provision in the U.S. tax code does not allow for the expensing of a building purchase, so this is a significant extra tax break for businesses within the EZ. By allowing businesses within the area to "immediately expense" rather than "depreciate" the cost of property, firms receive their tax breaks sooner, which lowers the present value of their net tax stream. In addition, this provision provides an incentive for businesses to purchase property in the EZ because it lowers the after-tax price of purchasing the property.

Capital Gains Exclusion: This provision allows qualified businesses (described above) to postpone the reporting of gains from the sale of qualified assets. These must be assets that have been purchased at least one year prior to sale and used mostly for business purposes within the EZ. By allowing businesses to postpone reporting these capital gains, this provision allows businesses to choose when they are taxed. Thus, businesses can postpone taxation, and hence lower the present value of their tax stream, or can shift taxes to years in which their marginal tax rate is relatively low. This component is also meant to spur investment in the EZ by lowering the cost of investing in capital there.

Stock Sale Exclusion: This provision allows taxpayers to exclude from taxation 60 percent of the gains from the sale of small business stock in EZ businesses for up to five years. For businesses outside a zone, only 50 percent can typically be excluded. The business must be a qualified EZ business for the

[2] For further details see: http://www.irs.gov/publications/p954/index.html.

most of the time that the taxpayer owns the stock. This incentive is given to anyone (regardless of whether they live in the EZ) who invests in the stock of an EZ business. By allowing some of the gain from selling this stock to be tax exempt, this provision also encourages outside investment in the EZ.

Facility Bonds: This provision allows state and local governments to issue tax-exempt bonds if the proceeds are used to provide EZ businesses (as described above) with qualified property (as described above)[3].

EZ Wage Credit: This provision gives firms a tax credit for the wages paid to qualified employees. The amount of the credit is 20% of the first $15,000 in wages paid to a qualified employee, for a maximum credit of $3,000 per employee. The qualified wages that are used to claim the EZ wage credit cannot be used as a deduction for salaries and wages. HUD maintains an address locator where businesses can find an employee's address to determine if an employee is qualified.[4]. Qualified employees must live in designated census tracts and be performing most of their work within the EZ. The EZ wage credit can be claimed for an employee only if the employee has worked at least 90 days. There is, however, no upper bound on the tenure of an employee receiving the credit. The following types of establishments are not permitted to claim the EZ wage credit; private or commercial golf courses, country clubs, massage parlors, hot tub facilities, suntan facilities, racetracks or other facilities used for gambling, and liquor stores.

It is worth emphasizing that the rules for claiming these tax incentives require the employer to be operating within the defined zone area. Moreover, the wage tax credit can only be received for employees working and living within the zone.

Initially, tax incentives were accompanied by $100 million in Social Service Block Grant funds allocated to cities with zones and to be used over the life of the program. Social Service Block Grants

[3] The Federal Government puts a ceiling on the maximum amount of tax exempt bonds that may be issued by state and local governments in each state. This maximum is currently set at $80 per state resident. Any bonds issued on behalf of EZ businesses were subject to the state maximum until 1999, when EZ bonds were no longer counted toward the maximum.

[4] Online at: http://egis.hud.gov/egis/cpd/rcezec/welcome.htm

can be used for a variety of services including: day care for children, employment services, counseling, legal services, transportation, education, and substance abuse recovery.

Many of the nominees who did not receive EZ status were given the “runner-up” award of Enterprise Communities (EC) status, which involves a less generous overall package of assistance with a limited set of tax incentives. Table 1 summarizes the zone type and associated benefits for the EC and EZ designations.

Local Economic Effects of Zone-Based Tax Incentives

Despite the growing popularity of zone-based tax incentives among policy makers, there is incomplete and contradictory evidence as to how these incentives impact the targeted population and surrounding area. For example, Mitchell Moss, Professor of Urban Policy and Planning at New York University suggests that trying to attract business to inner city areas does not work as an economic development strategy,

> Inner-city neighborhoods…(have) too many problems to make them attractive to private business, and, moreover, the residents of those communities, suffering from social problems no amount of economic development could cure, and residents wouldn't take any jobs that might be created in their backyards and so wouldn't benefit.[5]

Others claim that the Empowerment Zone idea works well because it creates the catalyst necessary for local leaders to begin addressing these problems through economic development. Representative Charles Rangel (D-NY), the principal author of legislation creating the federal EZ program, describes the hope for the program:

> (Empowerment Zones) …provide communities in this country an opportunity to break free from the cycle of ubiquitous poverty, unemployment violence, and drug abuse, and start back on the long, long road to self sufficiency and prosperity. It does not rely on the direction of bureaucrats in Washington or even the state houses or city halls, but on the energies and wisdom of local

[5] Comment taken from “Where’s the Power in the Empowerment Zone?” *City Journal*, Spring 1995.

leaders, their neighbors, and their institutions. The bill provides these communities with the tools and commitments necessary to rebuild and renew[6].

More formal evidence is provided by two studies that examine the effect of the federal EZ program, one by HUD and the other by an academic economist.

The HUD Study

The study by HUD measures the success of the EZ program by comparing the experience of businesses inside an EZ with businesses located in similar areas of the same city that were not chosen for EZ status. Similar areas were identified based on poverty rates, employment rates, racial composition, and median income. HUD argues that employment outcomes at the business level can be used to measure the creation of opportunities in the zone caused by the EZ incentives. The study admits, however, that total employment in zone businesses could grow without creating new opportunities for residents.

The study also admits that the use of comparison areas is a crude technique for isolating the effect of the EZ program. Undoubtedly, each city had other developments unrelated to the EZ program that had favorable or unfavorable effects on employment in the zone areas but not in the comparison areas. A simple comparison of employment levels cannot account for these confounding factors.

The main finding of the HUD study is that in almost all areas job growth rates were higher for businesses in the EZ than for businesses in the comparison areas for the first five years of the program (1995-2000). Five of the six EZ areas experienced employment growth from 1995 to 2000; only the Chicago EZ showed a decline in employment at zone businesses. In addition, four of the six EZ areas showed favorable employment trends during 1995-2000 relative to both the area's own prior growth rate and the growth trend in the corresponding comparison areas. These four EZ areas were in Atlanta, Baltimore, Detroit, and New York.

[6] Comments taken from testimony on H.R 15 The Enterprise Zone Community Development Act, January 5, 1993 (Thomas.loc.gov).

Other positive effects found by HUD included increases in the number of residents employed at businesses located in the EZ and an increase in the number of EZ-resident-owned businesses. However, the HUD study also found that employment growth occurring in the EZ areas was the result of an increase in the size of businesses rather than in their number. In fact, the number of businesses dropped between 1995 and 2000 in all six EZ areas, with the average employment per establishment rising in each area. Table 2 summarizes the findings for job growth at firms in the EZ and in comparison areas for all six cities.

The Academic Study

The academic study was conducted by Hanson.[7] This study measures the success of the EZ by comparing the difference between the economic outcomes of individuals living in an EZ and the outcomes of individuals living in the surrounding cities with the difference between the economic outcomes of individuals living in an area that received an EC and the outcome of individual living in the surrounding cities. For example, if part of New York City received an EZ and part of Houston was nominated for an EZ but only given an EC (see Table 1 for the difference) the effect of the EZ on employment could be measured in four steps. First, calculate the difference between the employment rate in the New York EZ and the employment in the rest of New York City for both 1990 and 2000. Second, calculate the difference between the employment rate in the Houston EC and the employment rate in the rest of Houston for both 1990 and 2000. Third, subtract the difference for each area in 1990 from the difference in 2000. Fourth, subtract the difference for Houston from the difference for New York. This "difference in difference" is a measure of the impact of the EZ program on employment..

Because both the comparison area and the EZ areas were nominated to receive an EZ, they have similar initial characteristics (poverty rates, unemployment, etc.). Normally, an across-city study of this kind would be problematic because different cities are subject to various economic shocks. The author argues that this problem does not arise in this study because the study compares the difference between the zone areas and the surrounding city to the difference between comparable areas and their surrounding

[7] Andrew Hanson, "Poverty Reduction and Local Employment Effects of Geographically Targeted Tax Incentives: An Instrumental Variables Approach," Unpublished manuscript, Syracuse University, January, 2007.

city. By comparing the zone area to the remainder of each city, this study eliminates the effects of any economic shocks that occur at the city level.

In addition, this study examines the changes between EZ and EC areas over the 1990's using data from before and after zones were designated. Making a comparison before and after zones were designated allows the study to net out any characteristics of the area that are constant across time that are specific to the area. For instance, if all EZ areas also had a job training program that was unrelated to the tax incentives and EC areas did not, we would not want to include the effects of this other program in our estimates of the EZ effectiveness. By looking at the change in economic outcomes over the decade this study further isolates the effect of the tax incentives from other area effects.

Furthermore, since this study compares the EC communities to EZ communities, it avoids the problem that the comparison area may have been adversely affected by the program, which is a problem with the HUD study. In fact, because the HUD study compares the EZ areas to areas of the same city that were similar before the program started, the results it reports are biased toward a positive outcome for EZ areas. If the EZ did attract economic development from outside of the zone, it is likely that it was transferred from areas that were similar, so the difference between these areas would look even larger than it would solely as a result of the positive benefits of the program.

The results of this academic study are mixed. The initial comparison shows that the EZ increased the employment rate of residents, decreased the poverty rate, and had no affect on incomes. Table 3 summarizes these initial findings.

However, the author argues that these results may be biased because of the way that zones were chosen. This initial comparison is only valid if EZ areas were chosen at random from the group of applicants, which may not have been the case. In fact, according to documents that detail the selection process of EZ areas, the zones were chosen based on the belief these areas were more apt to experience economic growth than other applicants.

A statistical method can be used to correct for the selection process involved in EZ designation.[8] After this correction is made, the positive effects found in the initial comparison are no longer present. This result indicates that the economic growth experienced by EZ areas compared to EC areas was almost entirely due to the fact that the areas most likely to succeed were chosen for EZ designation.

Issues

Even though the evidence on the EZ program suggests (although not definitively) that it may have some positive economic development benefits, several other issues need to be considered by policy makers. First, neither study is able to determine if any benefits from the EZ come at a cost to areas outside of the zone. It is important to consider to what extent economic development caused by the zone is redirected from businesses in nearby locations or in neighboring cities. Shifting of economic activity from neighboring cities would benefit Detroit, but the economic cost for those other cities could be high. Even within Detroit, redirection of economic activity could have some positive benefits, but it certainly will create winners and losers.

Of course a larger zone may limit the redirection of economic activity, but it would be more costly and more likely to award tax breaks to businesses that would have operated in Detroit regardless of the incentive. Because the EZ is usually a small part of a city, it could be that economic development occurring in the zone would have happened in other parts of the city if the incentives were not in place. In this way the EZ may not encourage new economic activity, but just move current activity into the zone. Although the general trend in Detroit is negative, Kwame Kilpatrick the mayor of Detroit touted the recent economic success of a downtown Detroit neighborhood:

> [The] 10th neighborhood also continues to grow. Detroit's central business district will soon rival those of other major cities, with three world-class casinos, two state-of-the-art sport stadiums, a new and thriving theatre district, linked river parks, a billion-dollar office and commercial complex, and several renovated office towers.

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[8] More formally, the EZ designation may be "endogenous" and an "instrumental variables" procedure, called two-stage least squares, is needed to eliminate the endogeneity bias. This procedure requires a variable that affects EZ designation, but not economic outcomes. The variable used by this study is whether the congressional district in which the zone is located had a representative on the House Ways and Means Committee, which plays an influential role in deciding on zone designation.

In order to minimize the cost of establishing an incentive program, it would be advantageous to avoid subsidizing economic growth that is already occurring. Placement of a new zone would need to balance these added costs with benefits that are a direct result of the incentives.

A second issue is who ultimately benefits from and who pays for the EZ tax incentives. Jack McHugh a policy analyst at the Michigan-based Mackinac Center for Public Policy argues that offering specific tax incentives is ultimately very costly for other taxpayers and will not solve the problems Michigan's economy faces;

> The targeted incentive approach will not work to fix Michigan's broken economy… (Tax incentives) have no impact on employment, the unemployment rate or per-capita personal income. For every $123,000 in tax incentives offered by the MEGA program, only one job was created — and those jobs lasted less than two years[9].

Others say that the entire state would benefit from a redeveloped Detroit, which could act as a catalyst for economic development in other areas of the state and help control the soaring costs that urban sprawl imposes. Bruce Katz, director of the Center on Urban and Metropolitan Policy at the Brookings Institute, suggests that;

> …environmentalists and business people share a rough agreement that urban sprawl is emptying Michigan cities, devouring farmland and sapping the state's economic competitiveness and quality of life.[10]"

He goes on to describe the growing costs of urban sprawl;

> the huge costs to state and local government of providing new highways, new schools and new water pipes to ever-more-far-flung subdivisions…taxpayer-funded debt— swollen by growth-related school-building and utility-line extensions— reached $8.9 billion in Metro Detroit last

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[9] These comments were made regarding the Michigan Economic Growth Authority (MEGA) tax incentives offered by the state of Michigan for business that create jobs in specific industries. Comments taken from "The Right and Wrong Approaches to Michigan's Economic Malaise" http://www.mackinac.org/article.aspx?ID=7698

[10] Comments taken from "Smart Growth Saves Money" http://www.brook.edu/views/op-ed/katz/20030413.htm

year, up 70 percent since 1993, when adjusted for inflation. Moreover, billions more dollars are needed soon for road and sewer repairs, as the state's urbanized area stretches ever farther.

The Decision

As the director of economic development for Wayne County, you are concerned with economic redevelopment of the county's largest city, Detroit. The State Legislature will be holding hearings on state economic development policy and would like your views on implementing a package of zone-based incentives in the Detroit area. Of course, they will want to know whether, and to what extent, this type of policy will aid in the redevelopment of Detroit. They will also be concerned that the policy might be prohibitively expensive for the state or detrimental to the surrounding areas. The State Legislature is aware of the federal EZ program and would also like to know your views on whether a state-run companion program could be designed using the experience of the federal program. If you believe a state-run EZ-type program is a good idea, they would like to hear about the provisions you think are most important to the program's success. If you believe such a program will not help Detroit, they want you to explain how you came to this conclusion.

Table 1. Benefits of Zone Designation

	Wage Credit	SS Block Grants	Cap Gains Exclusion	Stock Sale Exclusion	Facility Bonds	179 Expensing
EZ	Yes	$100 million	Yes	Yes	Yes	Yes
EC	No	$3 million	No	No	Yes	No

Source: Tax Incentive Guide for Business (HUD 2001)

Table 2. Business Job Growth Rates, EZ areas versus within City Comparison areas

	EZ area	Comparison Area	Difference Between EZ and Comparison
Atlanta	51%	25%	26%
Baltimore	31%	2%	29%
Chicago	-3%	32%	-35%
Detroit	15%	-12%	27%
New York	17%	-5%	22%
Philadelphia	9%	24%	-15%
Total for all areas	16%	7%	9%

Source: HUD Interim Assessment of Empowerment Zone Program, 2001

Table 3. Change in Residents Economic Status (Growth Rate for 1990 to 2000)

	Employment		Poverty		Average Income	
	Zone	City	Zone	City	Zone	City
EZ Areas						
Atlanta	-6.91%	1.21%	17.63%	10.59%	-29.02%	-25.88%
Baltimore	2.89%	8.03%	12.44%	-4.83%	-25.31%	-5.64%
Chicago	-15.16%	2.85%	21.26%	9.29%	-44.76%	-16.72%
Detroit	-30.90%	-6.77%	22.64%	19.55%	-36.78%	-16.31%
New York	2.83%	8.00%	9.54%	-10.17%	-23.45%	-2.68%
Philadelphia	-1.62%	6.21%	17.47%	-12.93%	-26.24%	-1.90%
EZ Average	-8.14%	3.25%	16.83%	1.92%	-30.92%	-11.52%
EC Areas						
Boston	-4.72%	3.48%	8.17%	-4.42%	-17.38%	-11.85%
Cleveland	-18.97%	-4.67%	22.37%	8.38%	-27.34%	-15.20%
Houston	0.98%	9.03%	22.59%	7.56%	-38.56%	-5.19%
Los Angeles	6.94%	13.48%	-4.53%	-17.25%	-0.07%	4.71%
Miami	17.69%	15.12%	11.65%	8.71%	-11.46%	-15.21%
Milwaukee	-21.80%	1.69%	22.99%	3.94%	-34.89%	-8.73%
San Francisco	-65.28%	-3.16%	53.15%	10.65%	-143.53%	-30.94%
Washington, DC	15.67%	8.18%	-12.71%	-19.86%	-11.47%	-13.27%
EC Average	-8.68%	5.39%	15.46%	-0.29%	-35.59%	-11.96%

Source: 1990 and 2000 U.S Census