Governor's Plan (AB 93)
New Programs and Enterprise Zone Elimination

Existing law authorizes the designation of up to 42 Enterprise Zones which offers various economic development incentives for businesses in economically distressed areas. Benefits include a sales tax credit, hiring tax credit and a net interest deduction. The cost of the current Enterprise Zone program is approximately $730 million.

The Governor's proposal eliminates the Enterprise Zone program in its entirety and replaces it with three different components of limited duration: a sales tax credit on the purchase of manufacturing equipment, a narrowly-targeted hiring tax credit that can be used within the boundaries of former enterprise zones and the poorest 25% of the state's census tracts, and a fund for the Governor's Office of Business and Economic Development (Go-Biz) to offer income tax credits on a negotiated basis to employers. AB 93 is considered revenue-neutral. When legislators cast their votes for this measure, some secured commitments by the Administration for various changes and other technical changes are expected. Those changes will be contained in a bill in the coming weeks, with SB 90 considered the vehicle.

Changes to Sales Tax Credits for Manufacturing Equipment
Currently, businesses located in an Enterprise Zone can take advantage of a sales and use tax exemption for purchases of manufacturing equipment, but the total cost of the purchases may not exceed $1 million for personal income tax filers and $20 million for corporation tax filers. This credit is available for the duration of the Enterprise Zone designation (Enterprise Zones initially receive a 15-year designation). The current cost of the sales and use tax component is not known because both the hiring tax credit costs and the sales and use tax exemption costs are combined. However, the Personal Income Tax portion for both costs approximately $293 million and the Corporate Tax portion for both costs approximately $414 million. Estimates put the sales tax component around $100 million.

Under the Governor's proposal, the sales and use tax exemption available under existing law is eliminated, as of January 1, 2014, in favor of a temporary statewide provision that will not take effect until July 1, 2014. The new sales and use tax exemption in AB 93 will be available statewide for the purchase of qualified equipment used for manufacturing, biotechnology research and experimental development in the physical, engineering and life sciences. The exemption allows up to $200 million in purchases from a single entity to qualify. AB 93 provides that the exemption would expire on:

- January 1, 2021, for purchases within an enterprise zone and areas within the 25% of census tracts identified by the Governor's office as having the highest rate of unemployment and the highest rate of poverty, and
- January 1, 2019 for the rest of the state.

As drafted, SB 90 would provide that the exemption would expire on July 1, 2022, 8 years after the sales tax exemption is put in place.

The Senate Budget Committee estimates that for 2013-2014, the state will spend $236 million on this provision, $86 million in 2014-2015, $521 million in 2015-16, and $531 in 2016-2017.

Changes to Hiring Tax Credits
Under existing law, businesses in an Enterprise Zone can hire individuals with barriers to employment including those that are economically disadvantaged, dislocated workers, disabled, ex-offenders, members of a federally-recognized Indian tribe, residents of a targeted employment area, etc. The incentives offered to businesses to hire these workers are robust as an incentive to hire individuals with barriers to employment and provide training to those who may otherwise lack qualifications. Businesses receive 50% of taxable wages up to $12 an hour for the first year of employment, 40% for the second, 30% for the third, 20% for the fourth, and 10% for the fifth year of employment. For example, an employer paying $12 an hour for 40 hours of work per week for 50 weeks would receive approximately $10,000 in a hiring tax credit (technically, closer to $12,000, except current law caps the amount earned in the first year) Businesses are eligible to receive up to $37,440 over five years for a single employee.

All types of businesses are eligible for the hiring tax credit regardless of whether this is a new position created or the retention of an existing position. Businesses are also authorized to carry forward earned credits which do not expire. While the exact figure for the hiring tax credit is not known, it is generally accepted that this is the most costly provision of the Enterprise Zone program at about $500 million.

AB 93 eliminates the above hiring tax credit as of January 1, 2014. Existing employers in enterprise zones can collect credits for any existing employee hired before that date for five years, and can carry forward any unused credits for up to 10 years.

An extremely narrowed hiring tax credit will be offered to businesses, subject to numerous restrictive conditions that are likely to limit interest in the program. Under the revised proposal:

<u>Much Less Being Offered</u>: An employer in an Enterprise Zone or one of the identified 25% census tracts would be eligible to receive a 35% credit only on wages offered between $12 and $28 per hour. For example, a business paying an employee $12 an hour will not receive any tax credit, but an employer paying $14 an hour for 40 hours a week for 50 weeks will receive a $1,400 tax credit. While the Governor's office has indicated that potentially an employer could earn up to $56,000 for the hiring tax credit if the employer pays at least $28 per hour, 40 hours a week for 50 weeks, this scenario is highly unlikely given the restricted pool of eligible employees, many who will lack marketable skills to be worth wages in excess of $12 per hour. SB 90 contains an amendment to the wage requirement from $12 an hour to $10 an hour for five pilot areas that are not yet known, except that Go-Biz has sole discretion over the designation of the pilot areas.

<u>Smaller Pool of Eligible Applicants</u>: The categories of employees eligible for the hiring tax credit are limited to individuals either:

a) Unemployed for six months,
b) Receiving the federal Earned Income Tax Credit,
c) Recently discharged from military service (separated in last 12 months),
d) Ex-offenders (convicted of a felony),
e) Cal Works recipients will be eligible in SB 90.

Many Businesses Ineligible: Excluded businesses include all retail, food related jobs, and temporary jobs (fast food, restaurants, car dealerships etc.), unless they are a small business having gross receipts of less than $2 million. SB 90 also contains a provision to also exclude all "sexually oriented businesses" from the hiring tax credit.

Only Added Jobs Count: AB 93 also contains a "net new" jobs provision. In order to qualify for any new credit, an employer must increase the total number of jobs from one year to the next. The new employee must remain employed for three years or any earned credits could be required to be returned. While the policy behind this requirement may seem logical, the result will be to remove the existing incentive to retain existing jobs in these disadvantaged areas of the state.

Offering is Temporary: The hiring tax credit expires in 2019. Given its limited duration and many limitations it is likely that this program will be undersubscribed and wither, resulting in little reason to continue such a program focused on former enterprise zones and census tracts with high numbers of poor and unemployed people in the future. Once the program sunsets, the savings can be shifted by the Legislature and Administration elsewhere.

Eliminates LAMBRAs, MEAs, and TTAs:
Existing law authorizes the Local Agency Military Base Recovery Areas (LAMBRA) program to attract reinvestment and create re-employment opportunities on certain former military bases. The program has tax incentives which are similar to those offered in the Enterprise Zone program. Existing law also authorizes Manufacturing Enhancement Areas (MEAs) to focus on stimulating job creation in the Border region by providing special state and local incentives to encourage business investment and promote the creation of new jobs. Finally, existing law authorizes Targeted Tax Areas (TTAs) to offer incentives similar to Enterprise Zones that are only available to businesses located in the TTAs. AB 93 repeals the existence of LAMBRAs, MEAs, and TTAs as of January 1, 2014. SB 90 contains a provision that would allow LAMBRAs to keep their boundaries, just like enterprise zones, for purposes of being able to qualify for the hiring tax credit.

Repeal of Net Interest Deduction
Existing law authorizes banks making loans to businesses in an Enterprise Zone to receive a net interest deduction to encourage investment in these disadvantaged areas. The cost of this program is approximately $23 million. AB 93 repeals the existence of the net interest deduction.

New Discretionary Go-Biz Fund
This is a new component that currently does not exist, but authorizes businesses to compete for available funds from Go-Biz. A five-member California Competes Tax Credit Committee consisting of the Treasurer, the Director of Finance, the Director of Go-Biz, and an appointee each from the Senate and the Assembly will determine which businesses receive a Personal Income Tax credit or a Corporation Tax credit based on the number of jobs created, wages paid and job retention. 25% of the money allocated to this program will be set aside for small business, but credits will be limited to $30 million in 2013-2014, $150 million in 2014-2015 and $200 million until 2019 when this program is set to sunset.

Winners and Losers Under AB 93
Given that the Governor's prior proposals to eliminate Enterprise Zones contemplated –as with redevelopment—simple elimination and sweeping all savings into the General Fund, the notion that these funds will be used for alternative economic development programs is at least a positive. The reality, however, is that all of these new programs have sunset dates. The significant tax increases in Prop. 30's are also temporary, so it is quite possible that as the sunset dates for these economic development programs approach, groups that rely on General Fund spending will strongly oppose any continuation of these programs.

California manufacturers will benefit by being able to deduct the state's portion of the sales tax from equipment purchases for the time that the credits are available. Larger companies may benefit more, given their potential ability to shift capital expenditures for the purchase of equipment. It can be argued that this exemption can help California manufacturing compete better with other states, but businesses often make their investment decisions over a longer timeframe than the exemption will be available. Many manufacturing companies plan 10, 15 and 20 years into the future. In order to take advantage of a sales and use tax exemption of up to $200 million in equipment purchases, smaller companies may need more than 7 ½ years to make that kind of investment.

Some businesses will, no doubt, also benefit from incentives that will be offered by Go Biz, but the process will be governed by a committee dominated by elected state officials, so politics can be expected and predicting beneficiaries will be difficult.

Given the elimination of the Enterprise Zone program and the extremely restricted hiring tax credit offered as a replacement, the true losers under this proposal are those lower-skilled and hard-to-hire individuals who benefited from jobs offered within these zones, which were set up in areas of poverty and high unemployment. While throughout the enterprise zone debate, many disparaged jobs offered wages at $10-$12 per hour, these were great opportunities for many individuals. The incentive for employers to offer such jobs to hard-to-hire individuals has been eliminated. If such jobs do become available, the more skilled and experienced will get them.

Also harmed by this proposal are the communities and businesses that entered into a partnership with the state to create a zone for a term of 15 years based upon criteria adopted by the state. Businesses moved into areas they might not otherwise locate in, built buildings, purchased equipment and hired people. Local governments also offered local incentives. By eliminating these zones before their 15-year terms expired, affected businesses, local governments and individuals hired under the program are left hanging, and doubts about the state's reliability as a business partner are further confirmed. Since retaining jobs in these areas is no longer incentivized, and the incentives for new jobs extremely marginal, it may encourage some businesses to consider expanding or moving elsewhere.

Veterans and LAMBRAs are affected as well. The hiring tax credit under the existing Enterprise Zone program offered many jobs to our military veterans, not those just recently discharged from service. In addition, the incentives under LAMBRAs also benefited the areas around former military bases. The constraints of the hiring tax credit under the Governor's program will limit veterans hired under this program.

Another negative outcome is that opportunities for local involvement in these programs have been eliminated. Enterprise Zones previously required the full cooperation and support of the local government with additional local incentives offered to businesses. All of these new programs involve business interaction with state officials. The sales and use tax program will be conducted by the State Board of Equalization, the Hiring Tax Credit by the Franchise Tax Board and the California Competes Tax Credit by Go-Biz.

Next Steps: When Legislators passed AB 93, the Capitol halls were full of rumors over what changes various legislators had obtained from the Administration. SB 90 will likely be the clean-up vehicle for AB 93. It remains to be seen what other alterations to AB 93 will be made as a result of those commitments.

Local governments should also realize that businesses in enterprise zones will remain eligible for hiring credits under the former rules of the program for any employees hired before January 1, 2014. This may spark an increase in local hiring before these incentives expire.