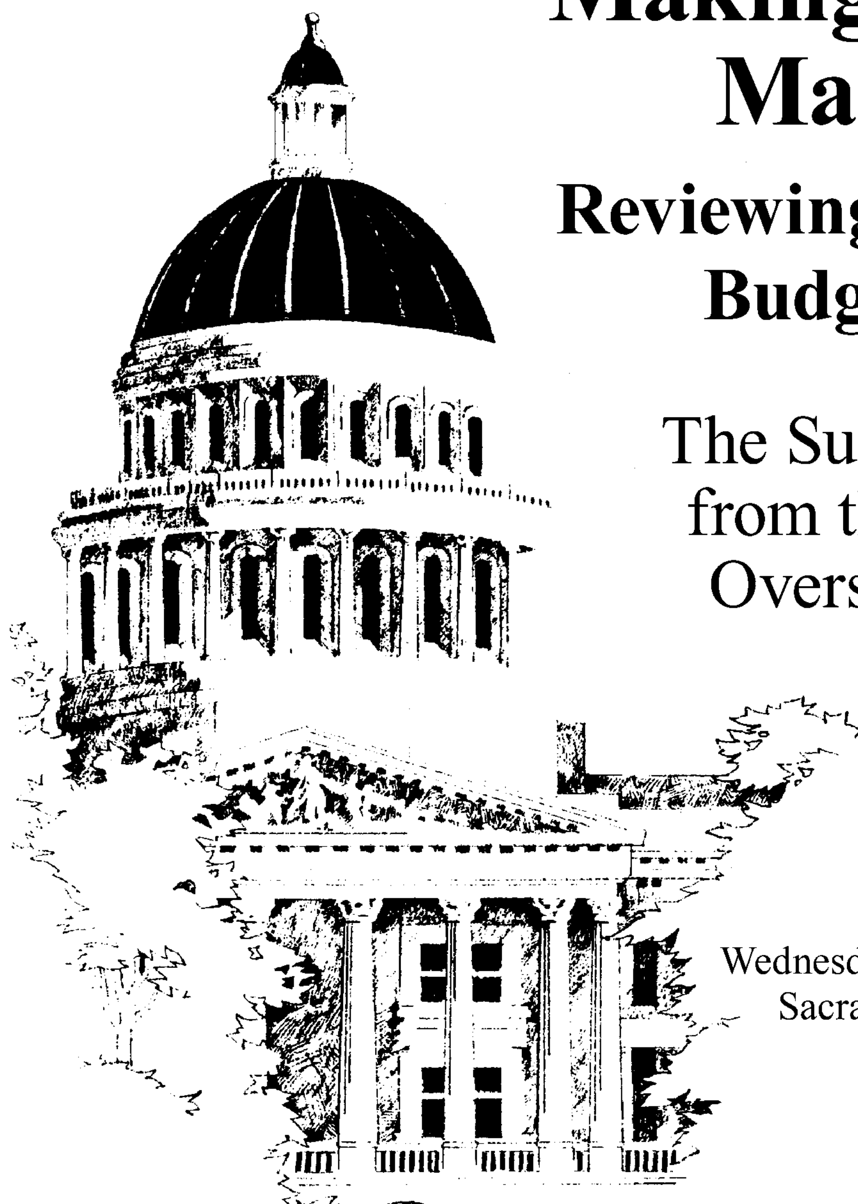
California State Legislature

Senate Committee on Governance & Finance

Making Tax Breaks Make Sense

Reviewing the Governor's Budget Proposal

The Summary Report from the Legislative Oversight Hearing



Wednesday, February 16, 2011
Sacramento, California

1494-S

COMMITTEE ASSISTANTS
MARISA LANCHESTER
KRIMILDA McKENZIE

CONSULTANTS
PETER M. DETWILER
TOBY EWING
COLIN GRINNELL
SAMANTHA B. LUI
GAYLE I. MILLER
BRIAN WEINBERGER

STATE CAPITOL, ROOM 408
SACRAMENTO, CA 95814
TEL (916) 651-4119
FAX (916) 322-0298

California Legislature

Senate Committee
on
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Making Tax Breaks Make Sense:
Reviewing the Governor's Budget Proposal
A Legislative Oversight Hearing

On Wednesday morning, February 16, 2011, the Senate Governance and Finance Committee held an oversight hearing on Governor Jerry Brown's budget proposal to repeal the enterprise zone program and make the single sales factor mandatory. The hearing at the State Capitol started at 9:30 a.m. and continued until 12 noon. Over 75 people attended the hearing.

All nine of the Committee's nine members participated:

Senator Lois Wolk, Chair
Senator Bob Huff, Vice Chair
Senator Mark DeSaulnier
Senator Jean Fuller
Senator Loni Hancock
Senator Ed Hernandez
Senator Christine Kehoe
Senator Doug LaMalfa
Senator Carol Liu

This report records who spoke at the Committee's hearing [*see the* ***white*** *pages*], reprints the Committee staff's briefing paper [*see the* ***blue*** *pages*], and reproduces the written materials provided by the speakers and others [*see the* ***yellow*** *pages*].

The Senate Sergeants-at-Arms audio-recorded the comments by the legislators and the other speakers. That recording is part of the Committee's official records of the February 16 hearing. A video recording of the entire hearing is available on the website of the California Channel:
http://www.calchannel.com/channel/viewVideo/2050

The Speakers

The Committee's agenda listed 11 invited speakers and 17 other people also spoke to the legislators about the Governor's budget proposal. This section captures the highlights of their comments. The appendix reprints what the speakers gave the Committee. [*See the* ***yellow*** *pages.*]

The Department of Finance's **Michael Cohen** spoke first, joined by Jay Chamberlain, his "tax guru." Cohen argued that the administration believes that enterprise zone program and redevelopment agencies are designed to move "economic activity to a particular location," and that the state should not spend hundreds of millions of dollars per year funding programs which do not demonstrate any new economic activity. Local economic development is not a core state responsibility. Instead, Cohen argued that the state's role is to create a stable economic environment statewide.

Cohen stated that the Budget Proposal ceases the program in the 2011 tax year, raising $924million in total, $581 of which is ongoing. Cohen stated that the administration's proposal cancels both new EZ tax credits and credits carried over from past returns, but allows taxpayers to amend previous returns and claim credits. Cohen additionally asserted that the Administration is on "sound legal ground" regarding cancelling carryover credits. Cohen stated that while reform efforts may have merit, the state's budget crisis is paramount and any EZ reform effort must find another way to find $581 million in ongoing savings. The state must focus on its core services, and continuing a program of limited success is not merited given the fiscal picture.

On the single sales factor, Cohen said that the Administration's proposal responds to the 2009 Budget deal that allowed multistate firms to choose between apportionment formulas. Instead of giving taxpayers a choice, the state should choose the best apportionment method and apply it to all taxpayers. Corporations that operate only in California cannot choose, and are therefore at a competitive disadvantage to their larger rivals. Additionally, elective single sales factor creates a disincentive for investment in California. A mandatory single sales factor puts California in line with other states, eliminates the disincentive, and provides $1.4 billion total ($1 billion ongoing).

James Nachbaur of the LAO brought two handouts, a new handout for enterprise zones and the LAO's May, 2010 report advocating for the mandatory single sales factor. On EZs, Nachbaur warned that taxpayers using credits does not mean the program is effective. Instead, discovering whether a tax credit program makes sense requires statistical analysis and plausible control groups; one cannot tell if EZs work unless one can find what would have happened had the EZ program not

existed. LAO's read of the best research is that EZs do not create jobs in the targeted areas because firms substitute eligible workers for non-eligible workers, and EZs may simply be moving jobs from one area of the state to another. Nachabaur said that the bottom is line is that the programs should be eliminated, but that the administration's proposal to void unused carryover credits negatively affects taxpayers who made decisions based on those credits, thereby undermining the effectiveness of all tax credits.

Nachbaur stated that the LAO agreed with the Administration's SSF proposal, and additionally pointed out that since the election only began this tax year, acting quickly minimizes uncertainty.

Senator Huff questioned the legality of revoking current carryover credits. Jason Sisney responded that Courts were unlikely to void the Administration's proposal, but strongly cautioned the Legislature to stick to its tax credit policies. Michael Cohen stressed that a timely adopted balanced budget is worth any uncertainty resulting from voiding these credits.

Senator deLeón stated that annual, elective single sales factor is bad tax policy. Senator deLeón stated that this policy is a giveaway to out of state firms, and provides incentives to cite payroll and property outside of California. He stated that a mandatory policy levels the playing field and helps create jobs, citing an LAO study projecting 40,000 new jobs and one billion dollars of revenue under a mandatory system.

Senator Wolk asked Cohen and LAO to help the Legislature identify criteria to evaluate whether tax credit programs work. Sisney stated that such an assessment is impossible. Randomized trials would be the only way to tell for sure, but the Legislature would have great difficulty implementing a program that way. Sisney stated that it's nearly impossible for researchers to determine what economic activity resulted from the credit, and what didn't. Sisney additionally suggested eliminating all tax expenditures using the revenue to lower all marginal rates, and put sunset provisions on all tax expenditures.

Single sales factor

Genentech's **Andrea Jackson** advocated for a mandatory single sales factor. She told the committee that Genentech has supported a mandatory single sales factor for over ten years even in states where the company would lose money under the tax structure because the company strongly believes there should only be one set of rules for companies. Genentech believes it is disingenuous to support mandatory single sales factor in other states, such as New Jersey, New York, and Washington while opposing the same system in California. Tax policies are often the most important reason for business location decisions. For example, Genentech built a $450 million facility with 250 jobs in Oregon due to that state's mandatory single sales factor policy. Single sales factor accounted for 10% of the project cost and the company would not consider a state that did not have a mandatory single sales factor. The mandatory single sales factor is "good for the budget" which in turn is good for business because a stable budget ensures that we continue to have a solid higher education system with an educated workforce to grow business across the state.

The California Budget Project's **Jean Ross** told legislators that her organization has historically opposed the single sales factor, mandatory or elective. If, however, legislators believe the arguments about economic development, she suggested that only a mandatory system makes sense. Ms. Ross cited the LAO's report on a hypothetical investment decision between Oregon and California as the best arguments for a mandatory system. While Ms. Ross associated herself with most of Ms. Jackson's remarks, she also made two additional points: First, that the elective system makes it easy for companies to game the system using the single sales factor when they make a lot of profit and flipping back to the three factor formula when they have a loss and the single sales factor when they have a gain. She told Legislators that the perverse outcome of choosing which tax to pay is a loophole that should be corrected. Second, she encouraged lawmakers that the market basis for intangibles is the only system that makes sense when using sales as a measure of taxation. A mandatory single sales factor is an important component of a difficult budget in the spirit of shared pain and sacrifice.

Carl Joseph of the Franchise Tax Board stated, when asked by Senator Wolk, that it would be much more difficult to administer two sets of sales factor rules because the old rules are intact for people that do not make the election. He also

emphasized that companies will make a determination in their best interest each year.

Senator deLeón attended the hearing on the issue of single sales factor and made four points related to the mandatory single sales factor. First, job creation is the most important reason for the proposal with 40,000 possible new jobs. Second, he stated that it was "obscene" that companies will game the system in California because it is the taxpayers that will ultimately subsidize job growth in Oregon. Third, that he believes there should be one set of rules for companies no matter where they are; he lambasted companies for passionately investing resources against a mandatory system in California while supporting it elsewhere.

Senator Wolk expressed concern that of seven companies and three associations invited to the hearing, only Genentech agreed to appear.

Public Comment

Terry Brennan speaking on behalf of the Service Employees International Union voiced his support of the Governor's proposal stating, "if Jean, Andrea & SEIU are on the same page—you have done something magical."

Enterprise Zones

Senator Wolk announced that **Eileen Norcross** was ill and could not attend, but sent written remarks.

David Neumark recapped his work showing that enterprise zones do not create jobs, and then discussed his new study on job creation policies. EZs don't specifically target job growth; instead they only allow firms in specified areas a credit for hiring workers with certain characteristics. Neumark recommended a hiring credit targeting the unemployed, stating that it reduces a firm's cost of employment, thereby increasing hiring. These credits are likely to help in the short run during recessions, but Neumark cautions that the evidence showing that EZ's do not lead to higher employment is much more conclusive and rigorous. Neumark estimated that these credits are seven times more effective than the most recent federal stimulus bill, but warned that the state enacting a hiring credit along these lines would only slightly ameliorate recent job losses at best.

Alissa Anderson spoke in favor of the Governor's Enterprise Zone Proposal because it strains the state budget without creating jobs or increasing investment in the state's distressed areas. Anderson argues that the program is expensive (under $1 million in 1986, growing to $466 million in 2008), doubling in cost every three to four years. Anderson states that businesses of over $1 billion in assets are the primary beneficiaries of the program, claiming 70% of the dollar value of the credits. Anderson asserts that the program is poorly targeted, allowing $26 million credits to firms in the San Francisco zone where unemployment is relatively low, and less than $1 million in Calexico where joblessness is more prevalent. Anderson recommends repealing the program, or reducing its scope to truly economically challenged areas and smaller businesses.

Chris Micheli opposed the Governor's proposal, and argued that this "unprecedented retroactive tax increase" will not result in the promised revenue gains because eliminating carryover credits is not allowed by the Contracts and Due Processes Clauses of the United States and California Constitutions. Micheli further questioned the revenue estimate because taxpayers unable to claim credits would simply take the wage expense deductions instead, a benefit the law currently bars for firms claiming EZ credits, and the estimate does not account for the fiscal effect of the deduction. Micheli also said that the "dynamic" effects of the proposal would result in less economic activity, and therefore lower state revenues. Instead of repeal, Micheli stated that reform efforts begun last year should be resumed.

Sara Flocks expressed the California Labor Federation's support for the Governor's proposal, because the program has failed and is fundamentally flawed. Flocks argued that the program subsidizes corporations to set up wherever they have already made a business decision to locate, citing Wells Fargo in San Francisco. Flocks stated that the tax credit's design rewards high-turnover low-wage jobs, not high-paying quality employment. Flocks asserts that the program essentially subsidizes a cottage industry of tax credit consultants that approach firms unaware of the program's benefits, go through the payroll records, and then file amended tax returns and refund claims for the firms in exchange for a fee contingent on the firm's tax refund. Flocks finished by saying that a state effort to stimulate job growth is needed, but spending on job creation through the tax code without transparency and accountability is "a recipe for failure."

Public Comment

Bill Dohring representing the City of Brawley expressed their opposition to the Governor's Proposal, arguing that the zone is very beneficial to local businesses.

Shane Gusman representing the Amalgamated Transit Union, the Teamsters' Union, United Food and Commercial Workers, and the Machinists spoke in favor of the Governor's Proposal, agreeing with Sara Flocks' testimony.

Todd Ament with the Anaheim Chamber of Commerce opposed the Governor's Proposal, saying that the City has lost 25,000 jobs in recent years, and the EZ program is vital for stopping firms going to other states.

Jeremy Smith with State Building and Construction Trades Union associated himself with the remarks by Flocks and Gusman.

Terry Brennan representing the Service Employees International Union questioned why the state spends one half of one billion dollars on a program that doesn't work, necessitating budget cuts to other state programs.

Brian Rees representing the California Poultry Federation stated that Foster Farms and Zachy Farms, large processors in the Central Valley, use the credits to mitigate competitive disadvantages against processors in other states with lower costs. Rees says that these tax credits are taken into consideration when deciding where to cite new facilities.

Sidney Singleton with the California Black Chamber of Commerce said that many minority-owned businesses are in enterprise zones, and these firms hire members of color, often with serious barriers to employment. EZs attract new businesses to California, create jobs, and help persons with barriers to employment find jobs.

Tim Nelson, Vice President of Marketing for Nor Cal Products in Siskiyou County, said that his business has grown significantly since the inception of the program.

Nancy Vellis with the Eureka Enterprise Zone urged the Committee not to eliminate the program, relaying the story of Lost Cost Brewery which used the tax credits.

David Jones representing the Cities of Lancaster, Palmdale, and Sacramento stated that cities make a significant investment to get the zones going, urging reform instead of elimination.

Dan Carrigg with the League of California Cities opposed the Governor's Proposal. Eliminating the zones would break faith with local agencies, and the firms that chose to locate and hire persons in the zones.

Yolanda Benson representing the California Association of Enterprise Zones said that the Governor's Proposal is already having a tangible, negative effect on business decisions in Imperial and Los Angeles. Benson cited a business survey stating that the program created or retained 118,000 jobs last year, including 2400 ex-offenders.

Senator LaMalfa asked how the Legislature can quantify the area's that are being reached, how to reform the program, and improve accountability in the program. Benson stated that jobs are in industrial areas, not in residential ones, but the law qualifies zones based on poverty indicators specific to households.

Yolanda Lee, the EZ Manager in San Jose, said not eliminating the program is important. Manufacturing companies create blue-collar jobs that do not have to be in California have been called by other states, and this program is the only incentive for these firms.

Tanya Dowse, representing the Siskiyou Enterprise Zone, said that 500 jobs were created or retained in the zone, and the program represents a "community survival strategy."

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STATE CAPITOL, ROOM 408
SACRAMENTO, CA 95814
TEL (916) 651-4119
FAX (916) 322-0298

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Senate Committee
on
Governance & Finance

LOIS WOLK
CHAIR

Making Tax Breaks Make Sense

The Governor's Proposal to Repeal Tax Expenditures

A Legislative Oversight Hearing

Wednesday, February 16, 2011
State Capitol, Room 4203
9:30 a.m. to 12 noon

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Part One: Reviewing the Governor's Budget Proposal

This briefing paper prepares members of the Senate Governance and Finance Committee for their February 16th, 2011, oversight hearing on Governor Jerry Brown's budget proposal to eliminate enterprise zones and make the single sales factor mandatory.

In his January 31st state-of-the-state address, Governor Brown talked about his proposal to eliminate redevelopment agencies:

> *California faces a crisis that is real and unprecedented. Each of us will have to struggle with our conscience and our constituencies as we hammer out a sensible plan to put our state on a sound fiscal footing, honestly balance our budget and position California to regain its historic momentum.*
>
> *Although our state's economy has started to recover, we will not create the jobs we need unless we get our financial house in order. It's absolutely essential that we do our work boldly and without delay.*

The Committee's review supplements the Legislature's process for reviewing the fiscal effects of the Governor's Budget. Senate Budget Subcommittee No. 4 reviewed the enterprise proposal on February 1st. On Monday, February 7th, the Assembly Budget Subcommittee No. 4 conducted its review.

The February 16th hearing is the fourth in a series of hearings in which the Committee explores how to best align agencies' outcomes with the revenues that support its activities. The hearing gives legislators a chance to look more closely at four questions:

- What did the Governor propose for tax policy in general, and enterprise zones and corporate taxes specifically?
- What questions should legislators ask before acting on those proposals?
- What are the challenges and opportunities of eliminating enterprise zones and making single sales factor mandatory?
- What are some feasible alternatives to enterprise zones?

The Governor's Revenue Proposals

Released on January 10, within the Revenue Estimate discussion under "Other Revenue Proposals," the Governor's Budget Summary proposed to:

- Make single sales factor mandatory (Corporate Income Tax)
- Repeal enterprise zone tax benefits (Corporate Income Tax & Personal Income Tax)
- Create a tax shelter amnesty program (Corporate Income Tax & Personal Income Tax)
- Create a Financial institution record match (FIRM) program (Corporate Income Tax & Personal Income Tax)

This paper focuses on the first two proposals above. All proposals may be found at: http://www.ebudget.ca.gov/pdf/BudgetSummary/RevenueEstimates.pdf pages 42-47.

For the Budget Year (2011-12), the Governor proposes to require all corporations, except those corporations engaged in qualified agricultural, extractive, or banking activities, to use the single sales factor instead of allowing a choice between the single sales factor and California's method in place prior to 2009, a double-weighted apportionment formula consisting of a payroll factor, a property factor, and a double-weighted sales factor. Additionally, the Governor's Budget requires all taxpayers to source the sale of services and intangibles using a market approach, as opposed to the costs of performance method.

Consistent with his new model for funding economic development, including his proposal to eliminate redevelopment agencies, discussed by this Committee on February 9, the Governor's Budget proposes to eliminate all enterprise zone tax incentives and similar tax incentives for specific areas for tax years beginning on or after January 1, 2011. This table summarizes the revenue impact of these two proposals:

Proposal	Fiscal Effect
Modify current law to make this income apportionment factor mandatory instead of elective, including the "market rule"	2010-11: $468 million 2011-12: $942 million
Eliminate the income tax incentives currently available for certain types of expenditures made in the designated zones	2010-11: $343 million 2011-12: $581 million

The Legislative Analyst's Assessment

Single Sales Factor:

In May, 2010, the Legislative Analyst's Office (LAO) found that a formula with a higher weight on sales and lower weights on property and payroll promotes job growth to some extent, but that an elective single sales factor does nothing for the state's competitiveness. LAO found that:

- A formula with higher weights on sales and lower weights on property and payroll promotes job growth to some extent.
- With most states' formulas now based only on sales, the old formula that used property and payroll could put some California producers at a competitive disadvantage.
- Allowing firms to choose their formula every year arbitrarily favors some firms over others.

The LAO recommended that the state require all firms to use the single sales factor, which would help the state's competitiveness while limiting the cost to the budget.

The LAO posted this 12-page review on its website:
http://www.lao.ca.gov/reports/2010/tax/single_payer/single_payer_052610.pdf

Enterprise Zones

The LAO generally finds:

- Research findings on geographic tax incentives are rather mixed. Some investigations show a positive response and others suggest no impact.
- However, the overall weight of research results suggests that any response is likely to be small and may result in revenue losses that are significant relative to the benefits received.
- Most research indicates that these incentives have little if any impact on overall *level* of economic activity or employment. They do not have a positive impact on the statewide economic base.

Part Two: A Single Sales Factor Primer

The February 2009, state budget agreement changed the formula that multistate firms use to determine the share of its total income that is taxable in California (ABx3 15, Krekorian and SBx3 15, Calderon). Previously, firms used a weighted average of their California sales, property, and payroll compared to its totals. Starting in 2011, firms may choose to apportion using the sales factor, with the intent to encourage firms to locate payroll and property in California.

Apportionment Formula:

A multistate firm generates profits based on its operations in many states; and has a right under the U.S. Constitution to divide income between these states for tax purposes, a process known as "apportionment," to ensure that no state taxes more than its fair share of that firm's income. The 1957 Uniform Division of Income for Tax Purposes Act (UDITPA) created the three-factor apportionment framework to capture the factors of production; specifically, property to represent capital, payroll to represent labor, and sales to represent market presence.

In 1966, California adopted UDITPA where each of the three factors had an equal weight of one-third. In 1993, California adopted a "double-weighted" formula, reducing the formula's weights on both property and payroll from 33.3% to 25%, but increasing the weight on sales from 33.3% to 50%, thereby reducing that share of a the firm's income apportioned to states where it employs relatively more people and produces more goods in the state compared to its sales. Under the change, a firm with all or most of its production and payroll in California, but a smaller share of its sales, benefits from the change, whereas a firm that either employs few or no people or owns little to no property here, but sells into California, pays more tax. Many other states also changed the apportionment weights in the 1980s and 1990s to induce firms to maintain or relocate facilities and employees in the state.

Starting in 2011, California's apportionment formula allows multi-state firms to annually choose either the above apportionment formula or to use only its sales, commonly known as the "single sales factor."

Intangible Sourcing:

As part of the budget agreement of 2010 (SB 858, Committee on Budget & Fiscal Review, 2010), taxpayers electing the three-factor, double-weighted sales formula must use the **costs of performance method** to source sales of intangible items starting with the

2011 taxable year; taxpayers electing sales factor-only apportionment of income must source the sales of intangibles to California using **the market rule**. Intangibles are everything that isn't "stuff", and include all services, such as online stockbrokers and telecommunications, and licenses to operate software programs, among others.

Sales of Intangibles – "Costs of Performance."

A company includes no revenue from its sales of intangibles to California in the sales factor if the firm incurs a plurality of the costs associated with developing these products or services in another state; if the plurality occurs here, then the company includes all of its sales in its California sales factor. For example, a company that produces streaming video may spend $500,000 in California and $520,000 in Oregon when developing the service. The firm does not include any sales of its sales of streaming video in this state in its California sales factor, because it incurred most of its costs of performance outside the state. Had the firm incurred most of its costs of performance in California, the taxpayer must include all of its sales of the video service in its California sales factor.

Sales of Intangibles – "The Market Rule."

Under the competitively-neutral market rule, all firms source these sales based on the state in which the product or service is ultimately used, so all firms report sales based on how much they sell in the state, instead of where they invested when developing the intangible item or service. Each license for an operating system used on a California personal computer would be included in the software firm's California sales factor. In the example above, the firm would include its sales of the video service to customers in this state in its California sales factor.

The following chart summarizes California's history of both apportionment and intangibles.

	1966 - 1992	**1993-2010**	**2011**
Apportionment	3-factor formula	4-factor formula (double-weighted sales factor)	Elective (4-factor formula *or* single sales factor)
Intangibles	Costs of performance	Costs of performance	Cost of performance if elect 4-factor; formula; market rule if single sales factor elected

<u>Mandatory Single Sales Factor & Mandatory Market Rule:</u>

Beginning in January 2011, firms have the option to choose either the three-factor, double weighted sales formula or a single sales factor. The Governor's Budget proposal requires all firms to report taxes based only on the sales factor. The budget summary states:

> *The goal of moving to a single sales factor was to eliminate any tax disincentives that can arise due to investment in new plant (property) and payroll in the state. There is a good argument to be made that in order for California to be competitive with other states, it should allow taxpayers to apportion using a single sales factor.*
>
> *However, there is no reason—from an economic development perspective—to allow businesses to choose how their income will be apportioned. Requiring mostly "in-state" firms to use single sales factor removes a disincentive that they face, under double weighted apportionment, moving economic activity in California. Requiring "out of state' firms to use the single sales factor accomplishes the exact same thing. It removes a disincentive that they face, under double weighted sales apportionment, from moving economic activity into California.*

The LAO agrees with the Governor that elective single sales factor allows the taxpayer to essentially choose the tax it pays, creating an inequity allowing taxpayers who operate in more than one state two different ways to calculate their income. Multistate firms can choose the formula that will yield a lower tax than the other, while businesses that operate wholly inside California have no such option. This disparate treatment puts the wholly in-state businesses at a competitive disadvantage to its multi-state competitors, which tend to be larger.

In its January 6th, 2011 letter to Senator de León which suggests a mandatory single sales factor, the LAO describes scenarios for a hypothetical California company considering expansion in California or another state. The examples assume that the company operates in two states—Oregon with a mandatory single sales factor apportionment method and California with an elective method—and expands by doubling its property and payroll.

The company's sales and pretax profits are held constant, but varying them would not affect the relative tax burden in the two states as long as sales increased proportionately

in both states. Initially, as shown in Figure 1, the company has 90% of its property and payroll and 75 % of its sales in California. With a lower sales factor than property and payroll factors, this particular company elects to use the optional single sales factor apportionment method available to companies under existing California law beginning in 2011.

Figure 1
Hypothetical California Firm With Some Operations in Oregon
(Dollars in Millions)

	California				Oregon			
	Existing Optional Single Sales Apportionment Formula				Mandatory Single Sales Apportionment Formula			
	Amount In State	State's Share Of National Amount	Weight In Tax Formula	Share Times Weight in Tax Formula	Amount In State	State's Share Of National Amount	Weight In Tax Formula	Share Times Weight in Tax Formula
Sales	$150	75%	100%	75%	$50	25%	100%	25%
Payroll	180	90	—	—	20	10	—	—
Property	900	90	—	—	100	10	—	—
	California apportionment ratio			**75%**	Oregon apportionment ratio			**25%**
	x Total national profits			$200	x Total national profits			$200
	California taxable profits			$150	Oregon taxable profits			$50
	x California corporate tax rate			8.84%	x Oregon corporate tax rate			7.90%
	California Tax Payment			**$13**	**Oregon Tax Payment**			**$4**

The LAO goes into detail for every scenario the company could choose (the letter is enclosed in this packet and can also be found at: http://www.lao.ca.gov/reports/2011/tax/deleon_010611.pdf) The letter concludes that under the optional single sales factor apportionment in California, the company would choose to expand in Oregon as explained below.

Optional Single Sales: Lower California Taxes if Company Expands in Oregon. By contrast, if the company expands in Oregon, its sales factor in California would then be higher than its property and payroll factors (see Figure 5). It presumably would then *not* elect to use California's optional single sales factor. As a result, the company's California tax bill would fall—from $13 million in the prior figures to $11 million in Figure 5—as a result of the Oregon expansion.

Figure 5

Optional Single Sales: Less California Taxes if Company Expands in Oregon

(Dollars in Millions)

	California				Oregon			
	Existing Optional Single Sales Apportionment Formula				Mandatory Single Sales Apportionment Formula			
	Amount In State	State's Share Of National Amount	Weight In Tax Formula	Share Times Weight in Tax Formula	Amount In State	State's Share Of National Amount	Weight In Tax Formula	Share Times Weight in Tax Formula
Sales	$150	75%	50%	38%	$50	25%	100%	25%
Payroll	180	45	25	11	220	55	—	—
Property	900	45	25	11	1,100	55	—	—
	California apportionment ratio			**60%**	Oregon apportionment ratio			**25%**
	x Total national profits			$200	x Total national profits			$200
	California taxable profits			$120	Oregon taxable profits			$50
	x California corporate tax rate			8.84%	x Oregon corporate tax rate			7.90%
	California Tax Payment			**$11**	**Oregon Tax Payment**			**$4**

Mandatory Market Rule

The Governor's Budget proposal assumes a mandatory market rule for all businesses in the state citing the competitive advantage for in-state businesses.

Furthermore, under the costs of performance method, firms source sales based on its past investments. If the firm invested in developing software in Kentucky, the firm sources no sales to California, resulting in a sales factor of zero for firms that produce only intangibles. Costs of performance sourcing of intangibles rewards firms for avoiding California with its investment decisions by excluding sales made in the state from its sales factor, thereby lowering its California tax.

Some tax experts criticize the costs of performance because its vague language results in disputes between taxpayers and tax enforcement agencies. The market rule has its own implementation difficulties, as evidenced by FTB's recent interested parties meetings regarding developing market rule regulations. Additionally, the costs of performance method is a winner-take-all system. If the Kentucky software firm incurred some of the costs of creating a new program in California but more there, the firm sources no sales made to its California customers here. By moving halfway back from market rule to costs of performance, California gives up an important share of future revenue from the sales of intangibles and services as these items grow as a share of the economy and as sales of tangible items fall.

Part Three: An Enterprise Zone Primer & Alternatives

California's 42 enterprise zones are located in areas as diverse as the state itself. From Siskiyou County to Compton, and from San Francisco to Calexico, this program provides powerful tax incentives for firms that do business in these zones. However, are these tax incentives worth the cost during these times of fiscal crisis?

California's enterprise zone program, the result of collaboration between former Assemblymembers Pat Nolan and Maxine Waters (AB 40 and 514, 1984, respectively), has evolved from a well-intentioned legislative effort to use tax credits to draw investment into economically depressed rural and urban areas into an almost half-billion tax credit program referred to as California's best economic development program. The Department of Housing and Community Development (HCD) administers the program, taking over from the now-defunct California Trade and Commerce Agency in 2003.

Proponents state that the enterprise zone program is the state's best tool for economic development, citing accounts from taxpayers who say that they locate in California largely because of enterprise zone program incentives, which overcome disadvantages posed by California's tax and regulatory system. Supporters argue that the tax credits draw investment into economically distressed communities and provide incentives for firms to employ hard-to-hire individuals. However, detractors state that the program offers a poor return on the state's investment, especially the Targeted Employment Area (TEA) criterion, and the practice of "retrovouchering."

Zone Designation

Cities and counties apply to HCD to designate geographic areas in their jurisdictions as enterprise zones. HCD reviews applications, and may designate up to 42 zones statewide for 15-year periods. Geographic areas are eligible based on its unemployment rates, free lunch program participation, median income, plant closures, or history of gang-related activity. Currently, HCD has designated the maximum of 42 zones, adding Anaheim, Los Angeles (Harbor Gateway), and Santa Clarita Valley in December 2010, and can designate two new zones to replace zones expiring at the end of 2011. HCD has also chosen seven Local Agency Military Base Recovery Areas, two Manufacturing Enhancement Areas, and one Targeted Tax Area, which offer similar tax benefits to businesses located within its borders.

Tax Credits

Businesses located in enterprise zones may claim tax credits for hiring qualified individuals, for sales tax paid on equipment purchases, and can qualify banks for a net interest deduction for loans made to a zone business. Firms may also accelerate depreciation of equipment, and carry over 100% of losses.

The most significant incentive is the hiring credit. Employers inside an enterprise zone may claim a tax credit of 50% of the wages paid to a qualified employee in the first year, diminishing 10% per year until exhausted after the fifth year, up to 150% of the minimum wage. Businesses or consultants submit applications to qualify employees to zone managers who grant a voucher certifying eligibility if the employee qualifies. The firm then keeps the voucher and claims the credit on its tax return, which the Franchise Tax Board (FTB) may subsequently audit.

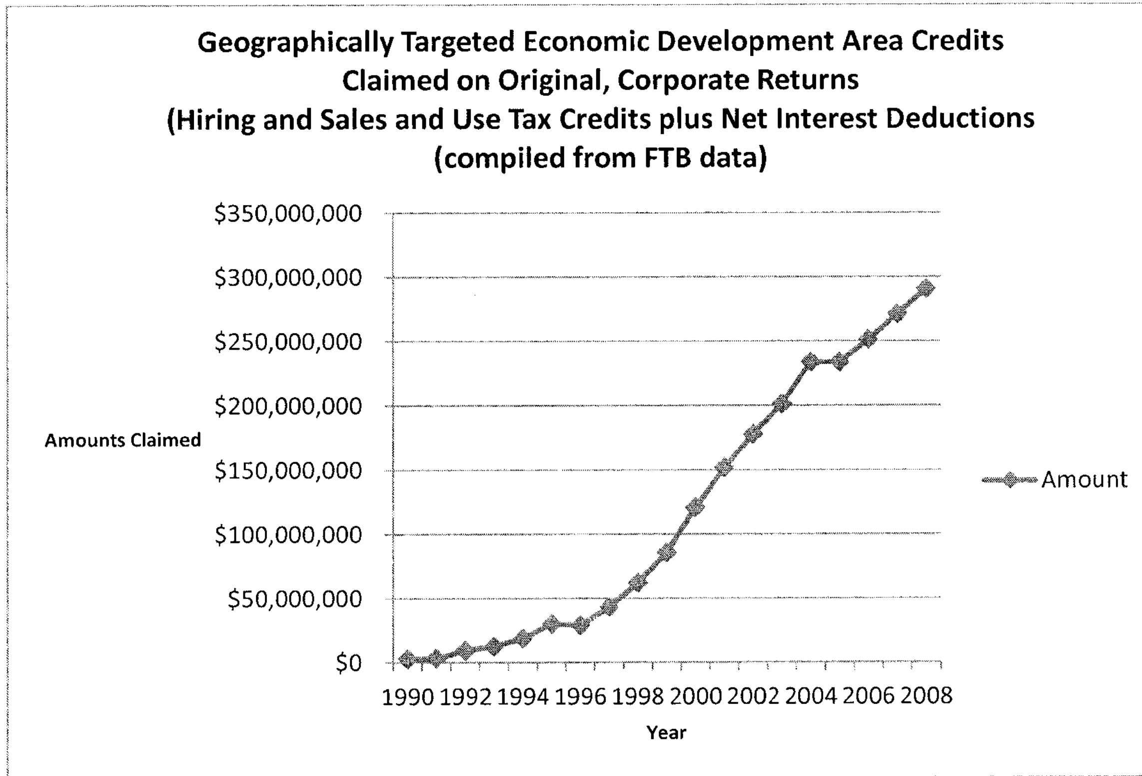
Qualified employees include individuals who are:

- Eligible for job training programs.
- Eligible for most social welfare programs.
- Economically disadvantaged.
- A "dislocated worker," as defined.
- A disabled individual who is eligible or enrolled in a state rehabilitation plan.
- A service connected veteran.
- An ex-offender.
- A member of a federally recognized Indian tribe.

Employers may also claim the hiring credit for residents of Targeted Employment Areas (TEAs), in addition to these criteria. Cities and counties managing enterprise zones may draw TEAs to contain census tracts where 51% or more of the individuals are low or moderate income, meaning 80% of the countywide median. In other words, local agencies draw TEAs to include communities where only half of the residents are actually or somewhat low-income, but anyone living in the TEA qualifies his or her employer for the hiring credit regardless of their own economic status or employability. TEAs need not be contiguous to, or drawn within, the borders of the Enterprise Zone.

Taxpayers can receive a certification qualifying an employee for an enterprise zone hiring credit at any time. Taxpayers may certify employees who worked for them in past years, then submit claims for refunds for previous taxes paid to FTB based on those certifications under California's general four-year statute of limitations for amending past returns, a practice known as "retrovouchering."

Fiscal Effect



At first, the program resulted in annual revenue losses of less than $10 million. However, beginning in 1998, the program's costs began to significantly grow because of an industrious cottage industry of accounting firms and tax credit consultants. These firms found that the program could be marketed to taxpayers, often under contingency arrangements, who were unaware of the hiring credit's generous benefits, which are worth up to $37,444 to an employer over five years if qualified wages reach or exceed the cap. Annual costs grew to exceed $100 million in the late 1990s, and continued to rise each year in the 2000s, now totaling $465 million in 2008, the most recent year for which data is available. The annual amount of the net interest deductions claimed ranges between $17 million and $34 million for the last eight years. Taxpayers mostly claim hiring credit (80% of the value of the remainder) and the sales and use tax credit (20%).

Academic Research

At the Senate Revenue and Taxation Committee's Enterprise Zone Oversight Hearing on March 10, 2010, the Committee received oral and written testimony from:

- Dr. Charles Swenson, whose work shows that enterprise zones have decreased unemployment and poverty rates in California census tracts within zones. [1]
- David Neumark, who found that California's enterprise zones have no effect upon employment and business formation in zones,[2] and zones which have lower shares of manufacturing and where managers perform more marketing activities have more favorable effects on employment, and zones that devote more time to helping firms claim tax credits eliminate any positive benefit.[3]
- Eileen Norcross of the Mercatus Center at George Mason University, whose written testimony stated that enterprise zones failed to produce the hoped for benefits of economic revitalization and robust economic growth because the policy is discriminatory and introduces complexity and gamesmanship into the tax code and business decisions. Norcross recommended that the state should instead set rules that encourage entrepreneurship without regard to firm size or business activity.
- LAO, which recommends that the program be eliminated or restructured.

Alternatives and Reforms

Speakers at the hearing will offer alternatives to the enterprise zone program to grant firms that hire unemployed workers and maintain overall employment above a certain level a tax credit. Another recommendation will be for the state to instead eliminate exceptions and exemptions currently in tax law, lower personal income and corporation tax rates, reform regulatory barriers, and focus on policies to reduce crime and improve educational outcomes to improve economic growth.

Should the Legislature want to maintain and enhance the enterprise zone program, it could:

- Remove the eligibility criteria that an employee must meet to qualify his or her for the hiring credit, thereby allowing a zone employer to claim the tax credit for any employee.
- Allow credits to reduce income beyond the amount the taxpayer earns in the zone. Currently, taxpayers may only claim the credit against net income derived from its

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[1] "Government Programs Can Improve Local Labor Markets: Evidence from State Enterprise Zones, Federal Empowerment Zones, and Federal Enterprise Communities," by John Ham, Ayse Imrohoroglu, and Charles Swenson, February 2009.

[2] "Do Enterprise Zones Create Jobs?" by David Neumark and Jed Kolko, Journal of Urban Economics, June 2010.

[3] " Do Some Enterprise Zones Create Jobs?" by Jed Kolko and David Neumark. Journal of Policy Analysis and Entrepreneurship, (2010), Vol. 29, No. 1.

operations in that zone where the employee qualifying the employer for the tax credit works.

- Enhance credit percentages, or removing the 150% of minimum wage cap for specified industries, such as manufacturing.

If the Legislature wants to maintain the enterprise zone program but potentially improve its cost-effectiveness, it can:

- Repeal the TEA criterion and retrovouchering.
- Limit tax benefits to firms under a certain amount of annual gross receipts.
- Require local agencies to reimburse the state for a share of the foregone revenue resulting from taxpayers applying tax credits in their zone.
- Reduce the number and size of zones, or place a statewide cap on the total number of square miles that HCD can designate as a zone.
- Tighten and focus the measurements of economic distress necessary for HCD to designate an area as a zone.

Part Four: What Legislators Should Ask

Economic Development

- *How are California's efforts best directed toward enhancing economic growth, given balanced budget requirements and the state's fiscal crisis?*
- *What policies can the Legislature enact that spur economic growth sufficient to fully or at least somewhat offset the resulting revenue loss, and cuts in public services?*
- *Where should the state focus its efforts? Small business employment? Interstate business migration? Firms that manufacture? Firms that manufacture primarily for export?*
- *What impact can state tax policy changes have?*
- *What impact can regulatory policy changes have?*

Enterprise Zones

- *Are the economic benefits of the enterprise zone program worth the cost to the state General Fund? Are the suggested alternatives better investments?*
- *Should California focus its efforts on economic growth statewide, or work on improving more economically depressed areas and providing incentives for hard-to-hire individuals? Are statewide policy changes more effective than locally targeted measures?*
- *Do Legislators agree with the Governor that the local economic development is not a core state responsibility?*
    - *If no, why are state dollars spent on local economic development a superior use to other programs such as health and human services or higher education?*
    - *If so, are the state's efforts better directed at statewide economic development policies? What works better than the enterprise zone program?*

- *Would more or fewer people have had jobs within enterprise zones had the state not enacted the tax benefits?*

- *Were jobs for which credits were claimed offset by losses elsewhere?*

- *Did the programs reward decisions by firms and local officials that would have been made anyway?*

<u>Efficacy of tax credit programs:</u>

- *In the last 20 years, only the Manufacture's Investment Credit (MIC) had a metric which required 100,000 new jobs within 10 years. Did that make the credit more or less effective? What are other measures to use to determine the efficacy of credits?*

- *How important is it to choose the correct performance measures in determining economic development for the state? What should the Legislature consider when designing performance measures?*

- *What lessons are there from performance review for spending programs that would be helpful in this regard?*

- *To what extent are the certainty of tax incentives more important than the notional value? For example, is it more important to have a permanent R&D credit than to increase it temporarily to 40%?*

- *Is the return on the investment on the enterprise zone program and the single sales factor superior to other alternatives? Why?*

- *Is it fair to evaluate tax expenditure programs in the way we evaluate spending programs?*

- *Could the Legislature improve the statewide economy by reforming the tax system? What is the best way to accomplish this goal? What would need to change—is it as simple as increasing the base and lowering the rate? What criteria should Legislators use to analyze tax policy in the context of economic policy?*

COMMITTEE ASSISTANTS
MARISA LANCHESTER
KRIMILDA McKENZIE

CONSULTANTS
PETER M. DETWILER
TOBY EWING
COLIN GRINNELL
SAMANTHA B. LUI
GAYLE I. MILLER
BRIAN WEINBERGER

STATE CAPITOL, ROOM 408
SACRAMENTO, CA 95814
TEL (916) 651-4119
FAX (916) 322-0298

California Legislature

Senate Committee
on
Governance & Finance

LOIS WOLK
CHAIR

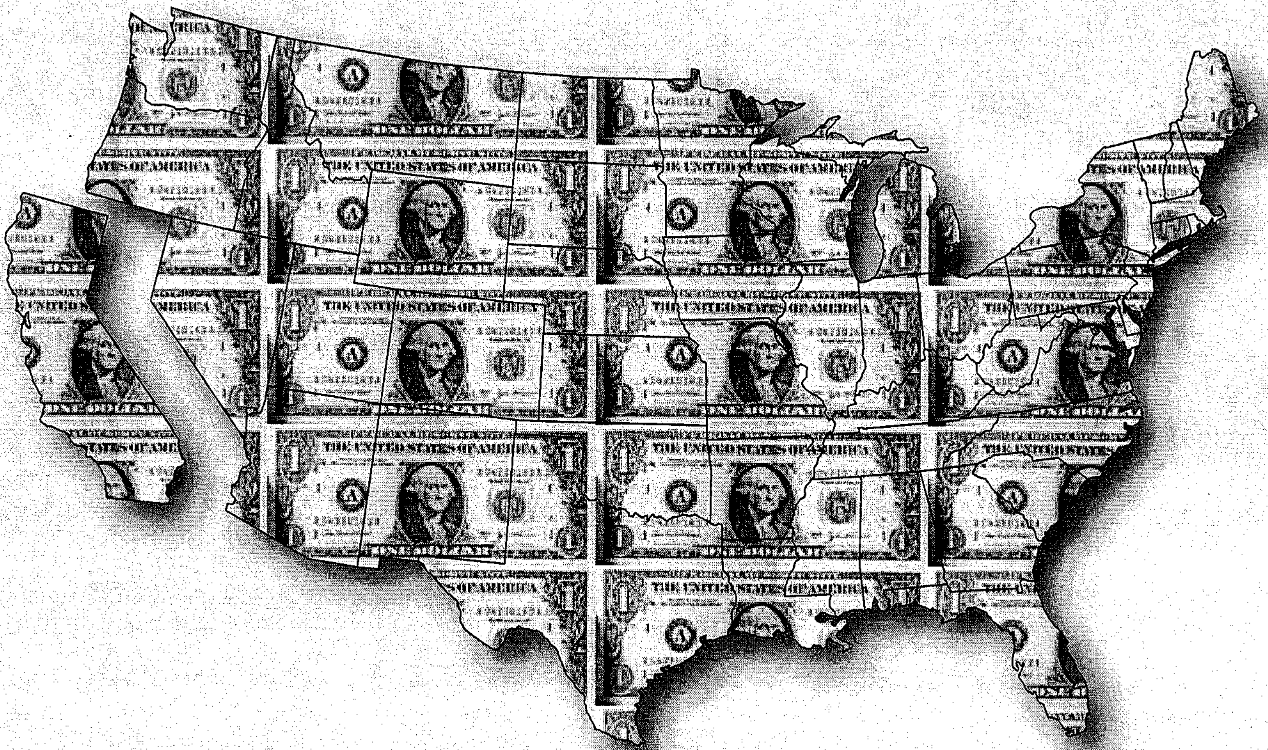
Making Tax Breaks Make Sense:

Reviewing the Governor's Budget Proposal

Written Materials Received by the Committee

Reconsidering the Optional Single Sales Factor

MAC TAYLOR • LEGISLATIVE ANALYST • MAY 26, 2010



EXECUTIVE SUMMARY

The February 2009 state budget agreement changed the apportionment formula used to determine California taxable income for firms that also operate in other states. While the current formula considers the location of firms' sales, property, and payroll, starting in 2011 firms will have the option to consider only their sales. This policy is intended to encourage firms to produce in California and sell into other states.

In this report, we examine the rationales for different approaches to apportionment and evidence from California and other states on how changes to apportionment laws affect both economic activity and tax revenue.

Our findings indicate that:

- A formula with a higher weight on sales and lower weights on property and payroll promotes job growth to some extent.
- With most states' formulas now based only on sales, the old formula that used property and payroll could put some California producers at a competitive disadvantage.
- Allowing firms to choose their formula every year arbitrarily favors some firms over others.

We recommend that the state require all firms to use the single sales factor, which would help the state's competitiveness while limiting the cost to the budget.

INTRODUCTION

The February 2009 state budget agreement changed the apportionment formula used to determine California taxable income for firms that also operate in other states. While the current formula considers the location of firms' sales, property, and payroll, starting in 2011 firms will have the option to consider only their sales ("single sales").

In this report, we examine the rationales for different approaches to apportionment and evidence from California and other states on how changes to apportionment laws affect both economic activity and tax revenue. We then compare the state's new law to other states' laws and recommend some changes.

FEATURES OF STATE APPORTIONMENT FORMULAS

Firms report profits only at the national level as opposed to the state level, so states have devised a process known as "apportionment" to determine what fraction of a multistate firm's profits they can tax. The term implies that the states in which a firm operates divide its profits up so that the sum of the taxable profits claimed by each state is equal to the firm's total. However, the reality is that each state in which the firm operates performs its own calculation using its own method. In all 45 states that levy a corporate income tax, taxable profits at the state level are based on the percentages of the firm's national property, payroll, and/or sales located in that state. States set their own relative weights on property, payroll, and sales. A firm that operates in states that use different formulas may find that the sum of its taxable profits in the states it operates is higher or lower than its overall national profits. In response to differing state formulas, firms have an incentive to use tax planning to minimize their overall state tax bill.

The three-factor apportionment framework comes from the Uniform Division of Income for Tax Purposes Act (UDITPA) that most states adopted following a 1957 meeting of the National Conference of Commissioners on Uniform State Laws. Despite the name, UDITPA has never been a federal law. Its policy rationale was that income should be apportioned based on the factors of production (property representing capital and payroll representing labor) and a sales factor to represent market presence. (Sales are counted in the state where a product is consumed, not produced.) Under UDITPA, each factor had a weight of one-third. California adopted UDITPA in 1966.

In 1993, California modified its formula by adopting a "double-weighted" sales factor. That is, the weights on both property and payroll are 25 percent, but the weight on sales is 50 percent. Many other states similarly reduced the weights on payroll and property and increased the weight on sales in the 1980s and 1990s. The rationale for this policy was to induce mobile firms that can produce in one state but sell into others (typically manufacturers) to locate facilities and employees in the state.

Alternatives to Apportionment. The only feasible alternative to an apportionment method is called separate accounting, which is used by the federal government. At the state level, it would mean that a firm would have to establish a California affiliate for tax purposes, and its

state taxable profits would be defined as receipts earned by its California affiliate (including "sales" to its own operations in other states) minus deductible expenses incurred in California. No state uses this method, as it would require much more bookkeeping than the current system and would encourage firms to game the system by putting unrealistic "prices" on their internal transactions so that their receipts are disproportionately booked in jurisdictions with the lowest tax rates.

Nexus. While there are no federal laws governing most aspects of state apportionment, federal case law prevents states from levying corporate income taxes on firms with no "nexus" (basically, physical presence) in the state. As a result, firms with minimal facilities in a state but significant sales may have an incentive to avoid any tax liability by reducing their presence in the state to the point where they no longer have nexus.

Throwback Rules. California is one of several states with a throwback rule, which means that sales shipped from California into states where the shipping firm has no nexus are "thrown back" and counted as California sales for corporate tax purposes. Because the throwback rule pertains to sales, it is more significant the higher the state's sales factor is relative to the other two factors. If a state has a throwback rule, firms that ship from that state will not have the incentive described above to avoid establishing nexus in states that they ship into. For example, under current law if a court rules that a firm that ships from California into Utah has no nexus in Utah, then Utah will not be able to impose its corporate tax on the firm. Instead, California will be able to count the firm's Utah sales as California sales for tax purposes. As an alternative example, if the firm initially had nexus in Utah, it could in some cases lower its overall tax bill by closing its Utah facilities and eliminating this nexus. This would likely be the case if Utah had a higher tax rate than California.

HOW APPORTIONMENT AFFECTS REVENUES AND INCENTIVES: A SIMPLE EXAMPLE

Apportionment's impact on a firm's tax bill depends on the distribution of its sales, property, and payroll among the states it operates in. For example, a hypothetical firm with $10 million of total profits operates in just two states: Alabama and Georgia. Its property, sales, and payroll are split as shown in Figure 1.

Alabama's apportionment formula puts equal weights of one-third on each of the three factors. In contrast, Georgia's formula uses only the sales factor and puts weights of zero on property and payroll. Figure 2 shows how the two states would compute the firm's taxable profits.

The firm has taxable profits of $8 million in Alabama and $4 million in Georgia for a total

Figure 1

Hypothetical Two-State Firm: Factor Allocation

(Dollars in Millions)

	Alabama		Georgia	
	Amount	Share of Total	Amount	Share of Total
Payroll	$45	90%	$5	10%
Property	360	90	40	10
Sales	60	60	40	40

of $12 million, yet its national profit is just $10 million. This arises because the firm's facilities are disproportionately in Alabama where the formula uses property and payroll, and its sales are disproportionately in Georgia where the formula uses only sales.

Switching the factor percentages from Figure 1 so that 90 percent of the firm's payroll and property and 60 percent of its sales are in Georgia instead of Alabama leads to a very different result. As shown in Figure 3, the firm's taxable profits at the state level add up to *less* than its national profits.

When states use different formulas (all else equal), firms have an incentive to locate their facilities in states that put more weight on sales and sell into states that put more weight on property and payroll. In this example, the firm's tax bill is lower if its facilities are concentrated in Georgia, which creates a policy problem for Alabama.

Figure 2

Hypothetical Two-State Firm: Taxable Profits Exceed Total

(Dollars in Millions)

	Alabama $^1/_3$ Payroll, $^1/_3$ Property, $^1/_3$ Sales			Georgia 100% Sales		
	Share	Weight	Subtotals	Share	Weight	Subtotals
Payroll	90%	33%	30%	10%	—	—
Property	90	33	30	10	—	—
Sales	60	33	20	40	100%	40%
Apportionment ratio			80%			40%
Share of $10 million in profits			**$8**			**$4**
Taxable Profits—Both States Total				**$12**		

Figure 3

Hypothetical Two-State Firm: Taxable Profits Less Than Total

(Dollars in Millions)

	Alabama $^1/_3$ Payroll, $^1/_3$ Property, $^1/_3$ Sales			Georgia 100% Sales		
	Share	Weight	Subtotals	Share	Weight	Subtotals
Payroll	10%	33%	3.3%	90%	—	—
Property	10	33	3.3	90	—	—
Sales	40	33	13.3	60	100%	60%
Apportionment ratio			20%			60%
Share of taxable profits			**$2**			**$6**
Taxable Profits—Both States Total				**$8**		

THEORY AND EVIDENCE ON APPORTIONMENT

Theory Is Inconclusive, Evidence Links Profits to Sales. There is no consensus among economists or other policy experts as to the theoretically appropriate factors or weights on each factor. As such, the assignment of equal weights under UDITPA was somewhat arbitrary. There is, however, some empirical evidence on the statistical relationship of profits to the three factors. A recent study of 11,000 European firms for which 2004 data on profits, property, payroll, and sales were all available concluded that the apportionment formula that best fit the data would use weights of 27.5 percent on property, 7 percent on payroll, and 65.5 percent on sales. A similar calculation for a smaller sample of U.S. firms suggests weights of roughly 45 percent on property, 5 percent on payroll, and 50 percent on sales.

Evidence Links Higher Sales Factor With Job Growth. In general, the evidence suggests that increasing the weight of the sales factor produces a small but noticeable increase in economic activity. Several academic studies which have covered all states over a decade or more and controlled for other factors that affect economic activity besides corporate taxes have found that a higher sales factor (all else equal) is associated with more economic development. For example, one used data for all states from 1978 to 1994 and found that on average, switching from a double-weighted sales factor to a single sales factor would increase a state's manufacturing jobs by about 3.3 percent. Another used data from 1978 to 1999 and accounted for some additional factors such as sales and property taxes, and reached a similar conclusion. A third, using data from 1987 to 1996 and accounting for some additional factors such as special tax incentives and public spending, found that a higher sales factor increases the amount of spending on business facilities and equipment. In addition to these studies, a number of other studies using data for either just one state or just one year have produced mostly similar results.

Results of a 2005 simulation using the California-specific Dynamic Revenue Analysis Model (DRAM) suggest that a mandatory single sales factor would create jobs on net—roughly one job for each $17,400 (in 2001 dollars) of initial revenue loss. (The simulation also accounted for the impact of state spending cuts that would be needed to offset the revenue loss.) This figure suggests that mandatory single sales could produce an eventual net gain of about 40,000 jobs based on the Franchise Tax Board's (FTB's) latest cost estimates. The DRAM estimate of the state and local revenue feedback effect from increased sales, property, and income taxes stemming from the job gains was about 14 percent of the initial revenue loss, which is consistent with the general empirical evidence on these effects. These estimates should be interpreted with caution as they are based on the 2001 state economy and incorporate a lot of assumptions, but we believe that they are reasonable ballpark figures.

STATE'S FORMULA WILL CHANGE IN 2011

Optional Single Sales Factor. As part of the February 2009 budget agreement, starting with the 2011 tax year, firms will be able to choose between the current double-weighted sales formula and a new formula that uses the single sales factor, ignoring the property and payroll factors. (The new law does not apply to banks and agricultural or mining firms. These firms will continue to use the UDITPA equal-weighted formula as they do under current law.) Firms will be able to decide each year which of the two formulas they want to use for that year.

Other Apportionment Changes. The state also modified some other provisions of the apportionment law to partially offset the cost of the formula change. It clarified the definitions of nexus and gross receipts, broadened the definition of sales attributable to "unitary" groups of affiliated businesses, and changed the treatment of sales of services.

Impact of 2009 Policy Change

Below, we discuss the likely effects of last year's policy change to give businesses a choice between the two formulas.

Some Firms Will Benefit From New Formula. Consider the choice between double-weighted sales and single sales for a hypothetical firm with $10 million of national profits that sells nationwide but has most of its operations in California (see Figure 4). The state has 80 percent each of the firm's property and payroll but just 20 percent of its sales.

Figure 4

Single Sales Versus Double-Weighted Sales: California-Based Firm

	Double-Weighted	Single Sales
Payroll	80%	80%
Property	80	80
Sales	20	20
California apportionment ratio	50%	20%
x Total U.S. profits (millions)	$10.0	$10.0
= California taxable profits (millions)	5.0	2.0
California Tax Payment at 8.84 Percent	**$442,000**	**$176,800**

The figure shows that a California-based firm would be able to reduce its tax bill by 60 percent by switching from the current double-weighted sales factor formula to the new single sales factor.

In contrast, Figure 5 (see next page) shows the same calculation for an out-of-state firm that has relatively high sales in California (14 percent) compared to its shares of property and payroll (4 percent each). This firm would save $44,200 under the current formula with double-weighted sales, so it will elect not to use the new formula.

Optional Formulas Will Favor Some Firms Without a Clear Rationale. Firms will benefit from being able to switch from one formula to the other depending on whether they are having a good year or a bad year. Consider what would happen if a firm records a $10 million *loss* instead of a $10 million profit. Now it wants to maximize the taxable loss, which can be deducted against its taxable income for prior years or future years. Figure 6 (see next page) shows this calculation for the two firms from the previ-

ous examples and a third firm that has balanced factors: 16 percent each of its property, payroll, and sales in California.

The California-based firm will now switch to double-weighted sales to maximize its loss, and the out-of-state firm will likewise switch to single sales. In contrast, the "balanced" firm records the same taxable loss under either formula and thus does not benefit at all from being able to choose. Similarly, a firm that operates only in California cannot benefit from choosing its formula because it does not use the apportionment method in the first place. In other words, the optional single sales factor gives a bigger benefit to out-of-state firms than to balanced multistate firms or California-only firms.

Revenue Impact. The FTB estimates that the switch from mandatory double-weighted sales to the current optional formula will reduce state revenues by $900 million annually by 2012-13 when it is completely phased in. (This includes the definitional changes, which would be expected to raise revenue on their own.) The estimated revenue loss would be somewhat lower—$50 million to $100 million annually—if all firms were required to use the single sales factor instead of retaining the option to stick with double-weighted sales. The FTB used its database of corporate returns from 2006 to construct these

Figure 5

Single Sales Versus Double-Weighted Sales: Out-of-State Firm

	Double-Weighted	Single Sales
Payroll	4%	4%
Property	4	4
Sales	14	14
California apportionment ratio	9%	14%
× Total U.S. profits (millions)	$10.0	$10.0
= California taxable profits (millions)	0.9	1.4
California Tax Payment at 8.84 Percent	**$79,560**	**$123,760**

Figure 6

Single Sales Versus Double-Weighted Sales: Money-Losing Firms

	California-Based Firm		Out-of-State Firm		"Balanced" Firm	
	Double-Weighted	Single	Double-Weighted	Single	Double-Weighted	Single
Payroll	80%	80%	4%	4%	16%	16%
Property	80	80	4	4	16	16
Sales	20	20	14	14	16	16
California (CA) apportionment ratio	50%	20%	9%	14%	16%	16%
× Total U.S. loss (millions)	$10.0	$10.0	$10.0	$10.0	$10.0	$10.0
= CA loss (millions)	$5.0	$2.0	$0.9	$1.4	$1.6	$1.6
California tax savings	$442,000	$176,800	$79,560	$123,760	$141,440	$141,440
Difference	**$265,200**		**$44,200**		**$0**	

estimates, and its assumptions about profit growth until 2012-13 are consistent with the forecasts used to develop the state's 2010-11 budget.

Other States' Use of Optional Formulas

State tax systems that allow firms to choose their apportionment methods are not common, and little evidence is available on the impact of allowing firms to choose. Four states currently have optional formulas of some type in place.

- ***Missouri*** is the only state currently that allows an annual election between single sales and the traditional three-factor formula. The state has not conducted a study on the impact of this policy that was adopted in 1973.
- ***Utah*** changed its law in 2005 to allow firms to choose between the traditional three-factor formula and a double-weighted sales factor for five years at a time. The law has not been in effect long enough for them to draw conclusions about its impact.
- ***New Mexico*** currently requires the traditional equal-weighted three-factor formula but is going to give manufacturers an option to go with a double-weighted sales factor starting in 2011. Firms will be required to use the double-weighted formula for at least three years before switching back to the equal-weight formula.
- ***South Carolina*** allows firms to petition the state's revenue agency to use an alternate formula if the firm believes that the state's prescribed formula (double-weighted sales through 2010, single sales for 2011 and beyond) does not fairly represent the firm's income. It appears that the department typically approves these requests. The state has conducted no studies on the effects of allowing this option.

Colorado had a longstanding policy of allowing firms to choose annually between double-weighted sales and equal weights, but replaced this system with mandatory single sales in 2008.

Alternatives to Optional Formulas. A few states use different mandatory formulas for different sectors, usually by mandating a higher sales factor for sectors that typically sell into other states. An example of this is Maryland, which uses a single sales factor for manufacturers but double-weighted sales for all other firms.

RECOMMENDATIONS

California has been criticized at times for having high costs of doing business. The single sales factor would reduce those costs for mobile firms who sell into national or world markets and are more of a flight risk than firms who sell only into the California market. The results of the DRAM simulations and other empirical evidence suggest that a higher sales factor (all else equal) generates some employment growth. The tradeoff is that it reduces revenue and forces the state to either raise other taxes or cut spending on public services. In view of this, we discuss below the merits of mandatory versus optional formulas, the single sales factor versus the double-weighted sales factor, and the timing of the implementation of any changes.

Choice of Apportionment Formula. Allowing a choice between single sales and double-weighted sales arbitrarily favors firms with disproportionately high or low California sales relative

to property and payroll. These firms will benefit most from switching their formulas around from year to year depending on whether they report a net profit or a loss, and will thus pay a lower tax rate over the business cycle than multistate firms with more evenly distributed factors or firms that operate only in California. Given these concerns, we recommend that firms be required to stick to a single formula.

Single Sales or Double-Weighted Sales? The strongest case for single sales concerns conformity to other states' policies. If all states impose a corporate income tax with a single sales factor and a throwback rule, then a multistate firm's total taxable income at the state level will be equal to its total nationwide income. As such, the playing field between multistate firms and California-only firms will be level. The same would also be true if all states used the double-weighted formula or the equal-weight three-factor formula. However, the dominant formula now among the large states is single sales: Texas, New York, Virginia, Georgia, Massachusetts, Illinois, Michigan, and Ohio all use single sales while only Florida, New Jersey, and North Carolina still use the traditional or double-weighted formulas. Pennsylvania is in between, with a 75 percent weight on its sales factor.

Conformity with other states would prevent California firms from being placed at a competitive disadvantage. Under mandatory double-weighted sales, a California producer that sells into states with single sales could well have total taxable profits in excess of its actual profits. For this and the reasons noted above, we recommend that the state use a single sales factor. We also recommend that the state keep the throwback rule to avoid the economic distortions discussed earlier.

Timing. Given the state's ongoing budget shortfall, we have recommended that the Legislature consider delaying the implementation of a number of tax policy changes that reduce state revenues enacted as part of the last two years' budgets. The state currently faces a nearly $20 billion budget shortfall for 2010-11. The following budget in 2011-12 will be challenging as well given the expiration of billions of dollars in temporary taxes. Consequently, we recommend that the Legislature delay any changes in apportionment policies for two years.

Overall Approach

In 2009, the Legislature signaled its intent to follow other states in switching to a single sales factor. While there is a good case for a mandatory single sales approach, providing it as an option creates clear disparities among businesses. We recommend that the state replace the optional single sales factor with a mandatory single sales factor beginning in 2013. This would increase state General Fund revenues by about $215 million in 2010-11 and about $700 million in 2011-12 and 2012-13 (due to the delay in implementation). Thereafter, our recommendation would increase revenues by up to $100 million each year.

LAO Publications

This report was prepared by Justin Garosi, and reviewed by Michael Cohen. The Legislative Analyst's Office (LAO) is a nonpartisan office which provides fiscal and policy information and advice to the Legislature.

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LAO

65 YEARS OF SERVICE

January 6, 2011

Hon. Kevin de León
Senator, 22nd District
Room 5108, State Capitol
Sacramento, California 95814

Dear Senator de León:

As you know, the February 2009 state budget agreement changed the rules used to determine California taxable income for companies that operate both in California and outside of California, effective for taxable years beginning on or after January 1, 2011. While the state's historical apportionment formula considers the concentration in California of firms' sales, property, and payroll, the February 2009 budget agreement provides that multistate firms will have the option each year to choose an alternate apportionment formula that considers only their sales. This is known as the "optional single sales factor" apportionment method.

Structure of This Letter. This letter responds to your request for additional information on single sales factor apportionment. Specifically, this letter discusses:

- The fiscal effects for the state's General Fund if California moved from elective optional to mandatory single sales factor apportionment, effective January 1, 2012.
- The effects of such a change on California's competitiveness with other states.
- Examples of the tax impacts for a hypothetical company considering expanding in California or another state with a mandatory single sales factor apportionment method.
- The California job gain estimate included in our May 2010 report that recommended the state move to the mandatory single sales factor.
- Our current recommendation to the Legislature concerning this issue.

Fiscal Effects of Mandatory Single Sales Factor Apportionment

About $1 Billion Revenue Increase by 2013-14. The Franchise Tax Board (FTB) estimates that moving to a mandatory single sales factor effective January 1, 2012 would increase General Fund revenues by $250 million in 2011-12, $850 million in 2012-13, and $1 billion in 2013-14, compared to existing law.

Estimate Assumes Current "Cost of Performance" Rules. As requested by your staff, these estimates assume that, under a mandatory single sales factor, companies follow cost of performance rules (now allowed in law only for companies who do *not* elect to use the existing

optional single sales factor). These rules allow a company to attribute *no* revenues from sales of other than tangible personal property to California in sales factor calculations if a plurality of the costs associated with these products or services were incurred in another state. For example, a company that performs a service, such as software testing, for a client based in California may spend $300,000 in California and $310,000 in Oregon in performing that service. For the purposes of determining the company's California taxes, none of this company's revenues from the California client count in tax apportionment calculations because a plurality of the costs of performing the service occurred outside of California.

Revenue estimates would be higher if, as an alternative, the current cost of performance rules were *not assumed* in the mandatory single sales factor fiscal estimate. If the cost of performance rules were eliminated from the estimate, FTB reports that the annual General Fund revenue increase for mandatory single sales effective in 2012 would increase somewhat. In this alternative scenario, FTB estimates a total General Fund revenue increase of $300 million in 2011-12, $1 billion in 2012-13, and $1.1 billion in 2013-14, compared to existing law. In this alternate scenario, the companies currently under cost of performance would attribute some intangible sales to California to the extent related products or services were received, used, or located here.

Effects of Mandatory Single Sales on Competitiveness

As we discussed in our May 2010 report, *Reconsidering the Optional Single Sales Factor*, there is a case to be made that the single sales factor formula promotes job growth to some extent and puts California producers on a more level playing field with producers based in other states. Broadly speaking, a switch to a mandatory single sales factor would tend to increase taxes for companies that have lower property and payroll factors than their sales factor. In other words, these companies have a greater share of their national sales in California than the California share of their national property and payroll. These are often companies that use property and labor to produce goods in other states and import them into California for sale. Companies, therefore, that make products in other states and ship them here for sale would tend to pay more taxes under mandatory single sales. While it is very difficult or impossible to project the precise overall effect of switching from optional to mandatory single sales for the state's economy, it is clear that different companies would be affected differently depending on their circumstances. We discuss some examples below.

Mandatory Single Sales Could Hurt Companies When They Lose Money. Mandatory single sales would hurt California-based companies, among others, in years when they lose money. (For purposes of this analysis, we consider California-based companies to be those with substantially higher concentrations of property and payroll in California relative to the concentration of their sales here.) This is because, under mandatory single sales, these companies would be unable to switch back to the double-weighted sales factor in the existing apportionment in order to claim more losses and, therefore, would have fewer losses to deduct against future profits. This would tend to increase these companies' state taxes over a typical business cycle.

Mandatory Single Sales Would Help Companies in Other Cases. While California-based companies would be able to deduct fewer losses under mandatory single sales, these companies

would benefit to the extent that they compete mostly with out-of-state companies who also have nexus in California and whose state taxes will rise proportionately more.

Examples of Corporate Expansion Under Elective and Mandatory Single Sales

You asked us to describe scenarios for a hypothetical California company considering expansion either in California or another state. Consistent with your request, the examples below assume that the hypothetical company operates in two states—Oregon (which has a mandatory single sales factor apportionment method) and California—and expands by doubling its property and payroll. The company's sales and pretax profits are held constant, but varying them would not affect the relative tax burden in the two states as long as sales increased proportionately in both states. Initially, as shown in Figure 1, the company has 90 percent of its property and payroll and 75 percent of its sales in California. As such, with a lower sales factor than property and payroll factors, this particular company elects to use the optional single sales factor apportionment method available to companies under existing California law beginning in 2011. (Note that companies with different characteristics would experience different expansion incentives than this hypothetical company. This discussion also does not consider all of the various factors, such as credits and deductions and non-tax factors, that affect companies' expansion decisions.)

Figure 1

Hypothetical California Firm With Some Operations in Oregon

(Dollars in Millions)

	California				Oregon			
	Existing Optional Single Sales Apportionment Formula				Mandatory Single Sales Apportionment Formula			
	Amount In State	State's Share Of National Amount	Weight In Tax Formula	Share Times Weight in Tax Formula	Amount In State	State's Share Of National Amount	Weight In Tax Formula	Share Times Weight in Tax Formula
Sales	$150	75%	100%	75%	$50	25%	100%	25%
Payroll	180	90	—	—	20	10	—	—
Property	900	90	—	—	100	10	—	—
	California apportionment ratio			**75%**	Oregon apportionment ratio			**25%**
	x Total national profits			$200	x Total national profits			$200
	California taxable profits			$150	Oregon taxable profits			$50
	x California corporate tax rate			8.84%	x Oregon corporate tax rate			7.90%
	California Tax Payment			**$13**	**Oregon Tax Payment**			**$4**

Mandatory Single Sales: No Tax Change if Company Expands in California. We then assume that the company expands its operations in California, doubling its payroll and property commitments. Assuming that California changes to a mandatory single sales factor, the hypothetical company would see no effect on its tax bill, as shown in Figure 2. The company's tax payment in each state remains the same as they were in Figure 1. This is because of the assumption that sales are held constant.

Figure 2

Mandatory Single Sales: No California Tax Impact if Hypothetical Company Expands Here

(Dollars in Millions)

	California				Oregon			
	Mandatory Single Sales Apportionment Formula				Mandatory Single Sales Apportionment Formula			
	Amount In State	State's Share Of National Amount	Weight In Tax Formula	Share Times Weight in Tax Formula	Amount In State	State's Share Of National Amount	Weight In Tax Formula	Share Times Weight in Tax Formula
Sales	$150	75%	100%	75%	$50	25%	100%	25%
Payroll	380	95	—	—	20	5	—	—
Property	1,900	95	—	—	100	5	—	—
	California apportionment ratio			**75%**	Oregon apportionment ratio			**25%**
	x Total national profits			$200	x Total national profits			$200
	California taxable profits			$150	Oregon taxable profits			$50
	x California corporate tax rate			8.84%	x Oregon corporate tax rate			7.90%
	California Tax Payment			**$13**	**Oregon Tax Payment**			**$4**

Mandatory Single Sales: No Tax Change if Company Expands in Oregon. Similarly, as shown in Figure 3, if the company expanded into Oregon its tax bills in the two states would not change. The tax payments in both states would remain the same as they were in Figure 1.

Figure 3

Mandatory Single Sales: No Tax Impact if Hypothetical Company Expands in Oregon Either

(Dollars in Millions)

	California				Oregon			
	Mandatory Single Sales Apportionment Formula				Mandatory Single Sales Apportionment Formula			
	Amount In State	State's Share Of National Amount	Weight In Tax Formula	Share Times Weight in Tax Formula	Amount In State	State's Share Of National Amount	Weight In Tax Formula	Share Times Weight in Tax Formula
Sales	$150	75%	100%	75%	$50	25%	100%	25%
Payroll	180	45	—	—	220	55	—	—
Property	900	45	—	—	1,100	55	—	—
	California apportionment ratio			**75%**	Oregon apportionment ratio			**25%**
	x Total national profits			$200	x Total national profits			$200
	California taxable profits			$150	Oregon taxable profits			$50
	x California corporate tax rate			8.84%	x Oregon corporate tax rate			7.90%
	California Tax Payment			**$13**	**Oregon Tax Payment**			**$4**

Optional Single Sales: No Tax Change if Company Expands in California. Now assume that California continues to use an optional single sales factor. As shown in Figure 4, if the hypothetical company expands in California, it would continue to elect to use the single sales

factor (because its sales factor for California would be less than its property and payroll factors), and as such its tax bill would not change.

Figure 4

Optional Single Sales: No Tax Impact for a California Expansion

(Dollars in Millions)

	California				Oregon			
	Existing Optional Single Sales Apportionment Formula				Mandatory Single Sales Apportionment Formula			
	Amount In State	State's Share Of National Amount	Weight In Tax Formula	Share Times Weight in Tax Formula	Amount In State	State's Share Of National Amount	Weight In Tax Formula	Share Times Weight in Tax Formula
Sales	$150	75%	100%	75%	$50	25%	100%	25%
Payroll	380	95	—	—	20	5	—	—
Property	1,900	95	—	—	100	5	—	—
	California apportionment ratio			**75%**	Oregon apportionment ratio			**25%**
	x Total national profits			$200	x Total national profits			$200
	California taxable profits			$150	Oregon taxable profits			$50
	x California corporate tax rate			8.84%	x Oregon corporate tax rate			7.90%
	California Tax Payment			**$13**	**Oregon Tax Payment**			**$4**

Optional Single Sales: Lower California Taxes if Company Expands in Oregon. By contrast, if the company expands in Oregon, its sales factor in California would then be higher than its property and payroll factors (see Figure 5). It presumably would then *not* elect to use California's optional single sales factor. As a result, the company's California tax bill would fall—from $13 million in the prior figures to $11 million in Figure 5—as a result of the Oregon expansion.

Figure 5

Optional Single Sales: Less California Taxes if Company Expands in Oregon

(Dollars in Millions)

	California				Oregon			
	Existing Optional Single Sales Apportionment Formula				Mandatory Single Sales Apportionment Formula			
	Amount In State	State's Share Of National Amount	Weight In Tax Formula	Share Times Weight in Tax Formula	Amount In State	State's Share Of National Amount	Weight In Tax Formula	Share Times Weight in Tax Formula
Sales	$150	75%	50%	38%	$50	25%	100%	25%
Payroll	180	45	25	11	220	55	—	—
Property	900	45	25	11	1,100	55	—	—
	California apportionment ratio			**60%**	Oregon apportionment ratio			**25%**
	x Total national profits			$200	x Total national profits			$200
	California taxable profits			$120	Oregon taxable profits			$50
	x California corporate tax rate			8.84%	x Oregon corporate tax rate			7.90%
	California Tax Payment			**$11**	**Oregon Tax Payment**			**$4**

This is one example of how the optional single sales factor in current law could give some California-based companies an incentive to expand into other states as opposed to expanding here in California. As such, the existing optional single sales factor appears to be counterproductive in some respects with regard to promoting job growth and corporate expansion in California.

Evidence on Job Growth

As we discussed in our May 2010 report, evidence suggests that increasing the weight of the sales factor produces a small but noticeable increase in economic activity. For example (see page 8 of that report), results of a 2005 simulation using the California-specific Dynamic Revenue Analysis Model (DRAM) suggest that a mandatory single sales factor could produce an eventual net gain of about 40,000 jobs relative to the three-part apportionment formula that California had in place as of 2001. (This analysis was based on data concerning California's economy as of that date.) These specific job-gain estimates should be interpreted with caution, as discussed in the report.

LAO Comments

Legislature Could Eliminate Optional Single Sales Factor, Effective in 2011. Earlier, we provided fiscal estimates assuming that the state eliminated the optional single sales factor and replaced it with a mandatory single sales factor effective in 2012. Alternatively, the Legislature could make this change to the mandatory single sales factor retroactively to the beginning of 2011. If it were to do so, the Legislature might want to take action in the early weeks of 2011 in order to give companies as much notice as possible of the change for their 2011 tax planning. Assuming companies use the cost of performance rules, FTB estimates that a change to mandatory single sales effective in January 2011 would increase General Fund revenues by $240 million in 2010-11, $850 million in 2011-12, and $1 billion in 2012-13.

LAO Recommendation. As discussed in our May 2010 report, we recommend that the state adopt a mandatory single sales factor of apportionment for companies that also operate outside of California.

If you have additional questions, please feel free to contact James Nachbaur of my staff at (916) 319-8365 or by e-mail at james.nachbaur@lao.ca.gov.

Sincerely,

Mac Taylor
Legislative Analyst

LAO
65 YEARS OF SERVICE

February 16, 2011

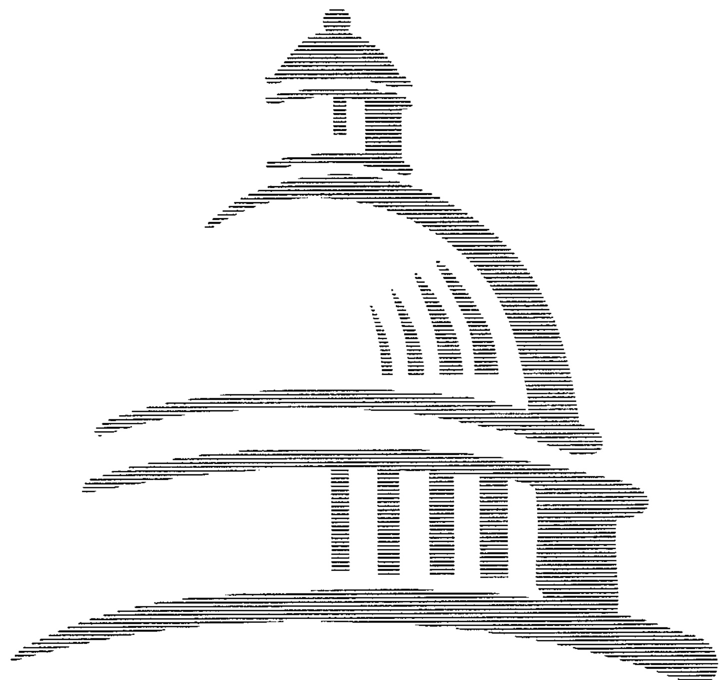
California's Enterprise Zone Programs

LEGISLATIVE ANALYST'S OFFICE

Presented to:

Senate Governance and Finance Committee

Hon. Lois Wolk, Chair



Program Background

- **☑ *Area Program Tax Benefits.*** About three decades ago, the Legislature began to use the state's tax code to benefit businesses and workers in areas that were deemed to be distressed. The intent was to mitigate the higher costs associated with doing business in those areas and to increase opportunities for certain people.

- **☑ *Several Types of Areas.*** Tax incentive areas—Enterprise Zones (EZs), Manufacturing Enhancement Areas (MEAs), Targeted Tax Areas (TTAs), Local Agency Military Base Readjustment Areas (LAMBRAs)—were selected based largely on socioeconomic characteristics of the area and on the prevailing level of economic distress there. Legislation was enacted in 1984 for EZs, in 1998 for MEAs and the TTA, and in 1993 for LAMBRAs.

Program Background *(Continued)*

☑ ***Areas Located Throughout the State.*** There are now 53 tax incentive areas in California.

☑ ***Various Types of Tax Benefits.*** Extensive tax benefits are or were available for each of the areas as shown in the table.

- Overall, the hiring credits are by far the most important—and expensive—such benefit.
- EZ tax benefits are available for having employees who reside in a Targeted Employment Area.
- An employee can be claimed for a hiring credit for up to five years.
- There are benefits other than those listed below, such as preferential treatment for state contracts.

	Hiring Credit	Longer NOL Carryforward Period[a]	Sales and Use Tax Credit	Accelerated Depreciation	Lender Interest Deduction
Enterprise Zones	X	X	X	X	X
Targeted Tax Areas	X	X	X	X	
Local Agency Military Base Recovery Areas	X	X	X	X	
Manufacturing Enhancement Zones	X				

[a] Recent legislation lengthened carryforward periods for all taxpayers.

NOL = net operating loss.

Program Usage

- ☑ ***Rapid Growth in Use of Hiring Credits.*** The number of employees claimed to be employed on tax returns grew from 24,190 to 103,999 between 1999 and 2008. In 2008, 36,976 were claimed as "new" employees.

    - In 2008, the hiring and sales tax credits resulted in $274 million of reduced corporation tax revenues for the state. This is around 60 percent of the total reduction in revenues from the corporation tax and the personal income tax.

- ☑ ***Substantial Benefits for Large Businesses.*** In 2008, around half of the EZ hiring and sales tax credits went to businesses that each had more than $100 million in assets. Around 40 percent of those credits went to businesses with over $1 billion in assets.

How to Evaluate Program Effectiveness

- ☑ The EZ programs are used extensively. Use, however, is not the same thing as effectiveness. In assessing these programs, the Legislature will need to consider:
  - Would more or fewer people have had jobs in the area if the state had used the money differently?
  - Were some or many of the jobs for which credits are claimed offset by losses elsewhere?
  - Did the programs reward decisions by firms and local governments that would have been made anyway?

Our Assessment of the Program's Effectiveness

☑ ***Programs Not Shown to Be Effective.*** Most rigorous research has found that EZs do not create a net increase in jobs or increase the rate of job creation.

☑ ***What Might Be Reasons for the Lack of Job Impacts in the Areas?*** These incentives may have an impact on economic growth, the distribution of economic activity, the composition of the workforce, and production decisions. Nevertheless, there are several possible reasons why they do not demonstrate a positive net effect on job creation.

- For example, favoring qualified workers with the hiring credit may lead to the loss of other jobs.

☑ ***Possible Statewide Jobs Impacts Limited.*** Even if an EZ has a positive effect on jobs *locally*, the incentives may just move jobs around the state. When deciding between different states to expand in, other factors can be more important than tax incentives.

Our Assessment of the Program's Effectiveness *(Continued)*

- ☑ ***The Area Approach Is Not Well Tailored.*** We do not believe uniform sets of statewide tax credits are the best ways to address the real and diverse problems certain people or places experience. These programs' weak results may be due to the different and complex reasons why investment has been pulled out of certain areas or why people without jobs and job openings are not well matched. Local governments could better devise portfolios of approaches to suit their particular needs.

- ☑ ***Retroactive Credits Are Poor Incentives.*** The ability of taxpayers to amend past returns and claim hiring credits removes the incentive aspect of the programs. In this sense, the programs provide more of a reward than an incentive.

- ☑ ***Current Tax Policies Pick Winners and Losers.*** These programs involve the states favoring certain businesses over others.

- ☑ ***Yet. . . Some EZs Better Than Others.*** That said, there is some evidence that some EZs are more effective than others and that people's incomes can go up even if no new jobs are created. Also, applying for or administering an EZ can indirectly increase the effectiveness of the organization of local development resources to promote business. For example, "red tape" can be reduced.

Governor's Proposal

☑ ***Eliminate Tax Benefits.*** The Governor proposes to eliminate these area program tax benefits, both for newly earned credits and deductions *and* for credits that have been earned in prior years, but have not yet been used.

- Between $1 billion and $2 billion worth of unused credits were carried forward from 2008.
- For example, under the proposal, an employee hired in 2009 and claimed for a credit in 2009 and 2010 could not result in tax benefits for 2011, 2012, or 2013.

☑ ***Over $900 Million of Proposed Budget Solutions.*** The Governor's proposal would lead to a General Fund revenue gain of about $343 million in 2010-11 and $581 million in 2011-12, according to the Department of Finance. (The 2010-11 amounts reflect the administration's new revenue accrual approach.)

LAO Bottom Line

☑ ***Recommend Eliminating These Programs.*** Because they are expensive and not shown to be effective, we recommend that the area programs be eliminated.

☑ ***Proposal to Void Unused Credits Raises Questions.*** The Governor's proposal to void unused credits businesses had expected to carry forward raises various issues. Businesses made decisions under the assumption the state would meet its credit commitment. Voiding unused EZ credits not only raises concerns about the state's treatment of businesses that have such credits; it also could weaken incentives provided by other credits.

- As an alternative to voiding existing unused credits, the state could either suspend their use temporarily or limit the amount of net income they could offset in a given year.

PPIC | PUBLIC POLICY INSTITUTE OF CALIFORNIA

How Can California Spur Job Creation?

David Neumark

with research support from Marisol Cuellar Mejia

Supported with funding from the Donald Bren Foundation

JUSTIN SULLIVAN/GETTY IMAGES

SUMMARY

California has short- and long-term labor market problems—there were steep employment declines during the recent recession, and the state's unemployment rate is persistently higher than the national average. Recent job losses have led to proposals for state policies to spur job creation. This report examines two "direct" job creation policies: subsidies to employers to hire workers ("hiring credits") and subsidies to individuals to enter the labor market ("worker subsidies"). Hiring credits act to increase the demand for labor, and worker subsidies aim to increase labor supply. Under normal circumstances, either policy should lead to higher employment. However, short- and long-term goals turn out to be of critical concern when considering the effectiveness of each policy.

In the short term, when recovery from the recession is the paramount goal, hiring credits are likely to be the better policy response. To be most effective, hiring credits should focus broadly on the recently unemployed and establish incentives for new hires rather than increases in the work hours of existing employees. In the longer term, when the labor market has recovered more fully from the recession and the focus can shift to the persistently higher unemployment in California, greater reliance on worker subsidies—most likely in the form of a state Earned Income Tax Credit (EITC)—would prove beneficial.

Either program would be costly to implement. Rough calculations suggest that the cost per job created using worker subsidies would be $12,000 to $207,000, and the cost for hir-

ing credits would be $9,100 to $75,000. These cost ranges do not take into account other fiscal or macroeconomic benefits associated with these policies, including such difficult-to-measure effects as reducing expenditures on unemployment insurance and welfare payments, increasing tax receipts, or stimulating the economy—all of which could lower the ultimate costs of these programs. But even if program costs were lower, feasible levels of state funding would at best contribute only modestly toward helping California's labor market recover from the recession.

Still, there may be good reason to pursue these policies, with short- and long-term goals in mind. If policymakers want to confront the aftermath of the recent recession, hiring credits can be made more cost-effective by using simple program rules and setting a relatively low hurdle for employers to claim the credit. When the state's economy and budget situation improve, the beneficial effects of a state EITC for low-income families might offset the EITC's greater cost per job produced. California might best follow other states and specify the EITC as an add-on to the federal EITC.

When the economy is strong, the state may want to rely less on hiring credits and more on worker subsidies to spur job creation. But to prepare for future recessions, a flexible approach may be best. California could create a hiring credit program that remains on the books permanently—one that aggressively rewards the hiring of unemployed workers during economic downturns but "turns off" during better economic times.

Please visit the report's publication page to find related resources:
http://www.ppic.org/main/publication.asp?i=939

Introduction

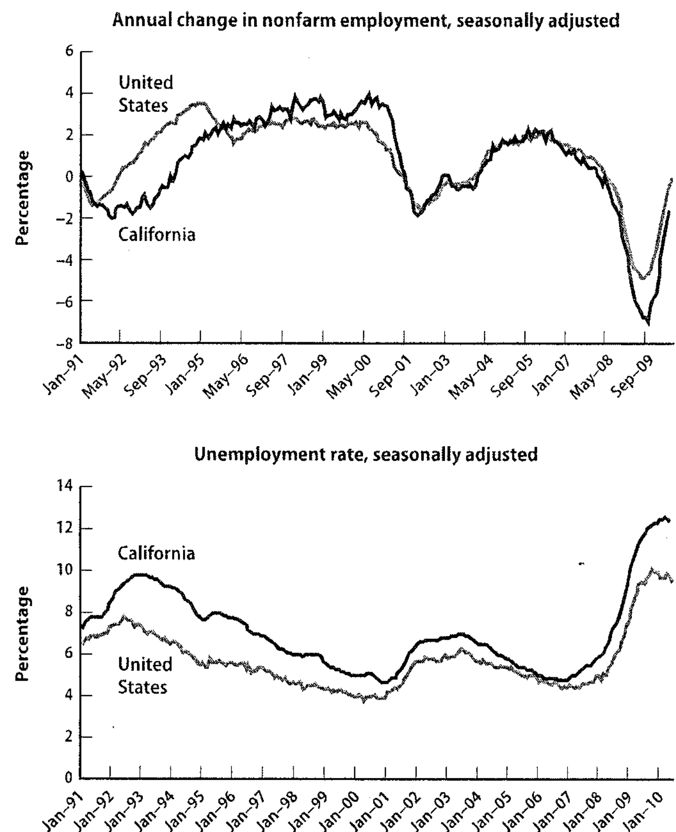
California has both short-term and long-term labor market problems. Of course, the short-term problem has received most attention lately. Job creation began to slow in 2007 and declined sharply in 2008 and 2009 in both California and the United States as a whole. However, in addition to these short-term cyclical changes, the unemployment rate is persistently higher in California (Figure 1).[1] Thus, although the scale of the recent job losses and the increase in the unemployment rate are striking, California's long-term unemployment problems suggest that policy debate about job creation policies should not focus *solely* on the short-term response to the recession.

This conclusion is reinforced by two facts. First, the state's current budget problems limit any short-term response. Second, the recent recession was sufficiently severe that even the best state policies would likely lead only to incremental changes; recovery from the recession in the state will require recovery at the national and international levels as well. State policy may be able to make a bigger dent in California's long-term unemployment problem.

This report focuses on two "direct" job creation policies that aim to increase employment by lowering the cost of labor. The first is subsidies to employers to hire workers ("hiring credits"). Hiring credits effectively subsidize wages when employers hire from particular groups of workers. Because these credits lower the cost of labor to firms, they increase the demand for labor.[2] The second is subsidies to individuals to enter the labor market ("worker subsidies"). Worker subsidies raise the effective wage that people earn from working, hence encouraging people to work and increasing labor supply. Economic theory predicts that, under normal circumstances, either policy

Recovery from the recession in the state will require recovery at the national and international levels as well.

Figure 1. The recession hit California hard, but state unemployment is persistently higher than the national rate



SOURCES: Data in the top panel are based on the Current Employment Statistics payroll survey; data in the bottom panel are based on the Bureau of Labor Statistics Current Population Survey.

should lead to higher employment. However, their actual effects may differ. As we shall see, hiring credits may be the best option for addressing California's short-term labor problem. But for the long term, worker subsidies are likely to be more effective.

To be clear, hiring credits or worker subsidies are not the *only* ways to spur job creation, nor are they necessarily the best way to do so. But they have the most direct effect on the behavior of either workers or firms that leads to more employment, and hence there is good reason to believe that these policies are likely to be the most effective at job creation.[3]

Certainly, state policymakers have proposed many policies that might create jobs. Examples include sales and use

tax exemptions for manufacturing, corporate tax reductions and reforms, a new state enterprise zone, reducing regulations, development of high speed rail, more school construction, lower capital gains taxes, and hiring credits for welfare recipients, veterans, and the unemployed.[4]

However, this report does *not* consider these policies or any other "indirect" job creation policies. Indirect policies change the economic incentives facing businesses or workers. They may increase employment, but in terms of the underlying economics, they do not directly target increases in the aggregate level of employment, and in some cases they may not increase employment at all.

For example, enterprise zones target employment growth in particular locations, rather than statewide, and may lead to employment growth in one place offset at least in part by employment declines in others or, as Kolko and Neumark (2009) find for California, may fail to create jobs altogether. Subsidizing business activities other than hiring, such as investment in machinery, could reduce employment by lowering the price of capital relative to labor. And policies that favor businesses generally—such as reducing taxes or regulatory costs—should help those businesses become more profitable and expand their workforces; but such policies do not necessarily reduce the relative price of labor, so the cost per job "produced" from such policies may be quite high.[5]

> Typically, job creation policies have more to do with smoothing out the business cycle, making the declines in employment and increases in unemployment less severe.

For the following discussion of hiring credits and worker subsidies, it is critical to understand clearly what "job creation" entails. In no way should it be inferred that a job created by either a hiring credit or a worker subsidy is permanent. People leave and enter jobs and the labor market frequently, particularly low-skilled individuals who would be the targets of either policy. But even if low-skilled individuals enter jobs that tend to be of short duration, if a policy leads to the creation of more such jobs or encourages more low-skilled individuals to look for work, then the economy will have a higher share of its population employed at any point in time—which can lead to a higher long-term level of employment.

The distinction between short- and long-term solutions to California's labor market problems marks an important theme throughout this report. Typically, job creation policies have more to do with smoothing out the business cycle, making the declines in employment and increases in unemployment less severe. This is true, for example, of a hiring credit policy that encourages employers to hire unemployed workers, because there will be more such unemployed workers during and just after a recession. (And it is certainly true of the recent federal stimulus package.) In contrast, the federal Earned Income Tax Credit—the principal worker subsidy discussed in this report—has been maintained continuously since its adoption and, for reasons discussed below, may increase employment over the long run despite being relatively ineffective at countering recessions. These differences in the timing—or "dynamics"—of the effects of hiring credits and worker subsidies inform the recommendations this report makes regarding the job creation policies California might adopt.

The remainder of the report proceeds as follows. First, hiring credit policies are discussed and reviewed in detail. Then, the predicted effects of these credits and—most important—the existing evidence on their effects are discussed. A similar discussion of worker subsidies follows. With the groundwork laid, arguments in favor of one policy or the other are presented and evaluated, including the costs of job creation under each policy and their relative effectiveness in addressing the short-term response to the recession and the long-term response to high unemployment in California. Next, the costs of these policies are estimated in light of the recent federal stimulus expenditures, to provide some guidance as to how much effect these programs—hiring credits in particular—could

ealistically have in terms of helping the state recover from the recession. Finally, some specific recommendations for making either policy more effective are discussed, followed by some more general recommendations for policies the state might consider in both the short and long term.

Hiring Credits

Hiring credits subsidize wages when employers hire from particular groups of workers. To a large extent, federal hiring credits have focused more on encouraging hiring among hard-to-employ groups than on countering downturns in the business cycle. In the past, Job Opportunities in the Business Sector (JOBS) targeted young disadvantaged workers, and the Work Incentives Tax Credit (WINTC) targeted Aid to Families with Dependent Children (AFDC) recipients. Other federal credits that targeted these groups and other disadvantaged individuals have included the Targeted Jobs Tax Credit (TJTC), the Work Opportunities and Welfare-to-Work Tax Credits (WOTC and WtWTC, which remain in place), and the Job Training and Partnership Act (JTPA).

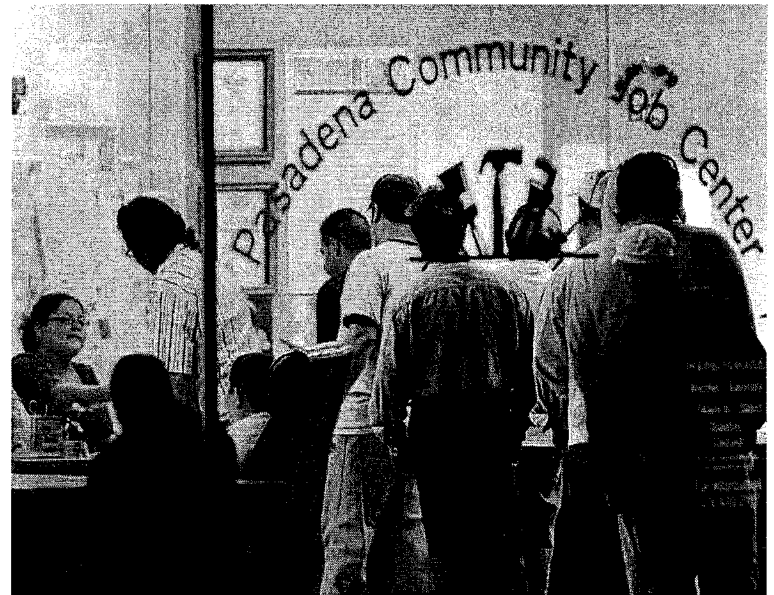
Using hiring credits to combat recessions has been less common. The federal New Jobs Tax Credit (NJTC) was enacted to counter the recession of the mid-1970s; it did not target particular groups but instead was "noncategorical."[6] The very recent Hiring Incentives to Restore Employment (HIRE) Act targets those who have been unemployed or who are entering employment from out of the labor force, offering a reduction in the employer's payroll tax burden for much of 2010. However, the HIRE Act does not explicitly target job creation by, for example, rewarding hiring only in growing firms.

States make extensive use of hiring credits. Table 1 lists current federal policies and examples of state policies. Some states (Florida and Maryland) focus on the unemployed, as does the federal HIRE Act. Others couple hiring credits with requirements for investment in facilities (Delaware) or training (Iowa). Some states tie the credit to what the new jobs pay. And almost all try to ensure that the credits are paid for new job creation.[7] Only a handful of states (including Maryland, Massachusetts, New Mexico, New York, and Rhode Island) currently have hiring credits targeting the disadvantaged, which is the focus of federal hiring credits.

California enacted a hiring credit (the New Jobs Credit, or NJC) in 2009. The NJC targets small businesses generally, rather than the disadvantaged or the unemployed (Table 2).[8] Hiring credit proposals in California in the past year have included expanding the employer size cutoff for eligibility for the NJC and targeting the unemployed or narrow, disadvantaged groups.

How Do They Work?

Economic theory predicts that a hiring credit will boost employment. Without a hiring credit, initial employment and wages are determined by the intersection of the labor demand and labor supply curves. Because a hiring credit reduces the effective wage paid by employers, it increases labor demand—meaning that employers would like to hire more workers than they would in the absence of the credit. This shift in labor demand leads to higher employment and also increases the wages paid to workers (which is why



ROBYN BECK/AFP/GETTY IMAGES

Hiring credits increase labor demand by reducing the effective wage paid by employers.

Table 1. Hiring credit programs, 2010

A. Federal		
HIRE Act	Exemption from employer share of Social Security taxes (6.2%) for March–December 2010; $1,000 tax credit per worker for workers unemployed or not employed (for more than 40 hours total) in 60 days before being hired, for those hired into new positions or into existing positions if the previous worker left voluntarily or for cause	
WOTC	Varying maximum credit amounts for long-term and other recipients of Temporary Assistance for Needy Families (TANF), veterans, recipients of Supplemental Nutrition Assistance Program benefits, residents of designated communities, summer youth, the disabled, ex-felons, Supplemental Security Income recipients, Katrina "employees," and disconnected youths hired for a two-year period; credit is a percentage of qualified wages, which are capped (percentage and cap differ by group)	
B. States (examples)		
Connecticut	New Jobs Creation Tax Credit	Discretionary tax credit up to 60 percent of the income tax for taxpayers that create and maintain at least 10 full-time new jobs
Delaware	Blue Collar Job Act	Credits up to 50 percent of firm's tax liability for eligible businesses that are engaged in a qualified activity, hire five or more qualified employees, and invest at least $200,000 ($40,000 per qualified employee) in a qualified facility; also $400 corporate income tax credit per employee and per $100,000 investment
Florida	Jobs for the Unemployed Tax Credit Program	Tax credit of $1,000 for each new hire who was previously unemployed for a minimum of 30 days and remains employed after a 12-month period at an average of 36 hours per week
Georgia	Quality Jobs Credit	Credit of $2,500–$5,000 per job per year, for up to five years, for companies that create at least 50 jobs with salaries of at least 110 percent of the county average; credit rises with ratio of salary to county average, from $2,500 for 110–120 percent of county average to $5,000 for 200 percent or more of county average
Illinois	Small Business Job Creation Tax Credit	$2,500 tax credit for employers with 50 or fewer total employees who hire new, full-time Illinois employees for new, full-time jobs sustained for at least one year; job must pay at least $25,000 per year
Iowa	New Jobs Tax Credit	Credit for businesses entering into jobs training agreement with a community college, and increasing base employment level by at least 10 percent; credit is 6 percent of qualifying wages
Maryland	Job Creation and Recovery Tax Credit	Credit up to $5,000 for hiring individuals receiving unemployment insurance benefits or who exhausted benefits in the previous 12 months and were not working full time immediately preceding the date of hire; hiring into full-time positions that are new or have been vacant for at least 6 months
Rhode Island	Hiring of Unemployed or Low-Income Residents	Credit of 40 percent (up to maximum of $2,400) for newly hired state residents previously unemployed or receiving public assistance; worker must have been unemployed for at least 26 consecutive weeks before being hired and either received public assistance for at least one year or received unemployment benefits at any time during the prior 52 weeks
West Virginia	Corporate Headquarters Credit	Tax credit offsetting up to 100 percent of tax liability for companies that relocate corporate headquarters to West Virginia and create 15 new jobs (including relocating employees)

NOTE: Currently, more than 40 states have statewide hiring credits (excluding statewide but not local enterprise zones).

more are now willing to work). However, the wage cost to the employer is less than the wage paid to the worker, with the difference exactly equal to the hiring credit. This simple logic probably underlies the perception that hiring credits are the most effective way to spur job creation.

In practice, however, complications can reduce—perhaps substantially—the effects of hiring credits.[9] First, because the goal of hiring credits is to create incentives for employers to create jobs, a well-designed hiring credit tries to reward increases in employment that would not have otherwise occurred. This is difficult to accomplish. Research makes clear that a substantial share—often as high as 90 percent of total hiring credit payments—pays for hiring that would have occurred anyway; these

;yments are "windfalls" for employers.[10] Thus, policymakers usually end up imposing administrative requirements on firms claiming hiring credits to try to identify new hiring, and the cost of complying with these requirements can deter firms from using the program.[11]

The second complication arises when hiring credits are targeted at disadvantaged workers—as they often are. The targeting of hiring credits on disadvantaged workers can "stigmatize" them. When workers signal their eligibility for a hiring credit, they simultaneously tell employers that they have low qualifications and have not, in the past, succeeded in the labor market. Employers are therefore likely to regard these eligible workers as less productive. Research indicates that, as a result, hiring credits that stigmatize workers can weaken or even eliminate the incentive to hire the very workers for whom the hiring credit is supposed to spur employment (Katz 1998). Moreover, documenting the eligibility of workers based on disadvantaged status can also entail administrative costs.

ɔw Effective Are They?

Much of the past research on the effects of hiring credits focuses on credits targeting the disadvantaged.[12] This research establishes some important findings about hiring credits that bear on their design and implementation, especially regarding the consequences of administrative costs and stigma effects. However, research on hiring credits used to counter recessions—in particular, the NJTC, which was in effect from mid-1977 to the end of 1978 to help spur economic recovery after the recession of the early 1970s—may be more relevant in thinking about policy responses to the recent recession.

In programs targeting the disadvantaged—such as JOBS and WINTC—a fairly small share of potential federal hiring credits is actually claimed by employers. Some interpret this low uptake as evidence of the detrimental effect of the high administrative costs involved with claiming hiring credits (Katz 1998). In contrast, the more broadly targeted NJTC was more likely to be claimed by employers.[13] Because the NJTC did not specifically target only disadvantaged groups, it may have entailed smaller administrative costs for employers.

Evidence that the NJTC was more effective at larger firms (Perloff and Wachter 1979) is also consistent with evidence on the importance of administrative costs. These costs likely have a large fixed component that can be spread over more workers at large firms. This finding suggests, therefore, that the effectiveness of California's NJC may be

Table 2. California's current and proposed hiring credit progams

A. Current	
New Jobs Credit (2009)	$3,000 per full-time employee (one working more than 35 hours a week for the whole year, otherwise prorated) hiring credit to small employers (fewer than 20 employees to start) that increase the number of full-time employees; credit capped at $400 million (cumulatively)
B. Proposed	
Governor's job package (State of the State, 2010)	$3,000 reimbursement for hiring previously unemployed Californians
SB 59 (Work Opportunity Tax Credit, R)	Tax credit to employer to hire someone in the California Work Opportunities and Responsibility for Kids (CalWORKs) program, parolees, probationers, veterans, or unemployment insurance benefit recipients
SB 63 (Veterans Hiring Tax Credit, R)	25 percent tax credit up to $6,000 of first year wages for each recently discharged and unemployed veteran hired and retained at least 120 hours
AB 2630 (Investment Tax Credit, R)	Expands NJC definition of qualified employer to 50 or fewer employees, retaining the $400 million cap and other features of NJC
AB 1973 (Re-Entry Tax Credit for Business, D)	Hiring credit up to $5,000 for first and second year of employment of ex-offenders convicted of a (nonsexual, nonviolent) felony

ΓES: Senate Bill (SB) numbers listed are for 8th Extraordinary Session. "R" or "D" denotes that the bill was introduced by a Republican or Democratic member. AB is Assembly Bill.

limited by targeting small firms. Moreover, high utilization of a program makes job creation more likely but does not guarantee it. For example, many claims under the TJTC were spurred by management assistance companies that helped employers file claims retroactively for eligible workers they had hired (Lorenz 1995).

There is stronger evidence on the detrimental aspects of stigma effects. Stigma effects can go so far as to eliminate the effects of hiring credits for narrow target populations. In an experimental program for welfare recipients, under the TJTC, one group received vouchers to present to employers for direct cash rebate subsidies; a second group received vouchers that let employers claim hiring credits under existing programs; and a third group was eligible for the same credits but neither received vouchers to give to employers nor were told that they were eligible. As it turns out, the third group had the most success in finding employment (Burtless 1985), likely confirming the adverse stigma effects for the other two groups.[14]

Despite stigma effects and administrative costs, what does the research literature say more generally about whether hiring credits boost employment? Hiring credits that target the disadvantaged can be effective at increasing employment for some groups, although often they are not. Moreover, when they boost employment, it is because they are combined with other efforts to help the targeted population find and keep jobs, through such efforts as job search assistance and job development.[15] Research also indicates that hiring credits targeting the disadvantaged do relatively little to increase the incomes of low-income families, because there are many nonpoor families with low-wage workers, and many poor families have no workers.[16]

Evidence on the effectiveness of the NJTC is more positive, perhaps because the NJTC avoided stigma effects by not targeting the disadvantaged and entailed lower administrative costs.[17] Firms that reported knowing about the NJTC had significantly higher employment growth (Perloff and Wachter 1979). However, this does not prove that the NJTC boosted employment growth, because firms where employment was growing may have had a "greater incentive to learn about the program" (Katz 1998, p. 31). Based on variation in employment growth when the credit was implemented, the NJTC appears to have increased employment in construction, trucking, retail, and wholesale trade by about 400,000 jobs, or about 0.5 percent of economy-wide employment (Bishop 1981).[18] However, it is not easy to sort out the effects of other aggregate changes affecting these industries from the effects of the NJTC.

A cautious conclusion, based on this evidence, suggests that the NJTC was effective at creating jobs, stating that a "temporary, noncategorical, incremental [worker] subsidy has some potential for stimulating employment growth" (Katz 1998, p. 31). This cautious conclusion echoes the authors of the original studies.[19] Recently, researchers calling for a federal hiring credit to counter the recent recession have argued, referring to the same body of evidence, that the evidence on the NJTC is unambiguously positive, arguing that "tax credits for new jobs have been tried before, and they worked well" (Bartik and Bishop 2009, p. 9), and that "the NJTC probably generated at least a million jobs by the end of 1978" (Bishop 2008, p. 5). Based on the evidence, however, the more cautious summary of the evidence along the line of Katz's is more defensible.[20]

In weighing the evidence, it is important to keep in mind that the NJTC was used over 30 years ago, which introduces considerably uncertainty in extrapolating results to the present. Furthermore, none of the existing evidence comes explicitly from state hiring credit policies, which introduces yet another source of uncertainty in trying to predict the likely effects of a hiring credit in California. But the relatively pessimistic conclusions about the effectiveness of hiring credits apply to programs that target the disadvantaged. A broadly focused hiring credit program that targets the recently unemployed and intends to counteract a recession may be more effective.

Worker Subsidies

In contrast to hiring credits, worker subsidies encourage people to work by supplementing labor market earnings with additional income. At the federal level, the EITC plays

his role, by subsidizing the employment of workers in low-income families. In 2010, the EITC paid a 40 percent subsidy on the initial earnings of families with two qualifying children; if, for example, the family earned $10,000 in the labor market, the EITC brought income to $14,000. This subsidy increases over the "phase-in range," up to a maximum credit (in 2010, $5,036 for families with two children). There is then a "plateau"—an income range over which the maximum benefit remains fixed. Finally, there is a "phase-out" range over which the credit is reduced by 21.06 percent of earnings until, at an income level of $40,363 for a family with two children, benefits have been eliminated. For families with one child, the subsidies are smaller, and there is a very small EITC available to those without children.[21] Many states also have their own EITCs, usually as a supplement to the federal EITC (Table 3). California has never had its own EITC, although proposals to establish one have been considered in the past (Table 4).

How Do They Work?

n contrast to a hiring credit, which increases labor demand, the EITC increases labor supply. Because the EITC raises a worker's effective wage (the market wage plus the EITC subsidy), it encourages people to work. For example, faced with a market wage of $8 an hour and no EITC subsidy, a single mother with two children may be better off if she does not work, given the costs of child care, clothes for work, and commuting. However, with a 40 percent supplement that brings her effective wage to $11.20, work may become more attractive.

Although it may seem counterintuitive, increasing the supply of labor to the market can—just like a hiring credit—increase employment. Before the worker subsidy is put into place, initial employment and wages are—again—determined by the intersection of labor supply and demand. The worker subsidy shifts labor supply, increasing how many people are willing to work at any wage—since workers receive a subsidy from the government for working, more of them are willing to work (or to work more) at any given market wage than they were in the absence of the EITC. Note that the market wage declines, owing to the increased number of people working, which is why employers are willing to hire more workers. But the worker's take-home wage—defined as the market wage plus the worker subsidy, is higher than the initial wage. Thus, although perhaps not as intuitively simple, the EITC acts just like a hiring credit—lowering labor costs to employers and increasing employment (and workers' pay).

Although it may seem counterintuitive, increasing the supply of labor to the market can—just like a hiring credit— increase employment.

However, just as in the case of hiring credits, complications arise that can undermine this process. In the case of the EITC, the main issue is the interplay of employment among family members. Some people may enter the labor market because of the EITC, but others may reduce the number of hours they work. Or some spouses of employed people (in contrast to single heads of household) may exit the labor market altogether. These effects arise in families in which earnings are above the phase-in range, because above the phase-in range, the EITC either gives families an amount of income that does not change with earnings (on the plateau) or reduces their income as earnings increase (in the phase-out range). Economic theory predicts that, for these families, there may be an incentive to reduce hours or, equivalently, for a secondary worker in the family to leave the workforce.

The complex effects of the EITC reflect the fact that it is not intended as a pure job creation policy. Rather, it is intended to increase the likelihood that low-income single women work. For this population, there is a clear prediction that employment will increase,[22] and more generally the EITC will increase incomes in low-income families. But there is no way to avoid the incentives that the EITC creates for those already employed (or who are secondary workers) to work less, because EITC benefits have to be

Table 3. The federal EITC and selected state EITC programs, 2010

A. Federal EITC, 2010				
	3 or more children	2 children	1 child	No children
Phase-in rate (% subsidy to earnings)	45%	40%	34%	7.65%
Maximum credit	$5,666	$5,036	$3,050	$457
Income at which maximum credit is reached	$12,590	$12,590	$8,970	$5,980
Income at which phase-out begins	$16,450	$16,450	$16,450	$7,480
Phase-out rate (% reduction in credit with additional earnings)	21.06%	21.06%	15.98%	7.65%
Income at which credit is eliminated	$43,352	$40,363	$35,535	$13,460

B. State EITCs, 2009	
	Percentage of federal EITC
Delaware	20% (nonrefundable)
District of Columbia	40%
Illinois	5%
Indiana	9%
Iowa	7%
Kansas	17%
Louisiana	3.5%
Maine	5% (up to $125 refundable for joint filers)
Maryland	50% nonrefundable or 25% refundable
Massachusetts	15%
Michigan	20%
Minnesota	Varies with number of children, averages 33%
Nebraska	10%
New Jersey	25%
New Mexico	10%
New York	30%
North Carolina	5%
Oklahoma	5%
Oregon	6%
Rhode Island	25% (nonrefundable, but 15% of amount is refundable)
Vermont	32%
Virginia	20% (nonrefundable)
Wisconsin	4% (1 child), 14% (2 children), 43% (3 or more children)

NOTES: In Panel A, the separate credit for three or more children is a temporary measure for the 2009 and 2010 tax years, included in the American Recovery and Reinvestment Act, after which the numbers for families with two children apply to families with two or more children. Numbers shown are for those filing singly. Phase-in and phase-out rates are the same for those filing jointly; incomes at which the phase-out rate begins and incomes at which the credit is eliminated are higher by $5,010 for those filing jointly. In Panel B, if not noted, state EITC is refundable. The dollar amounts are indexed.

SOURCES: Tax Policy Center, Urban Institute, and Brookings Institution (www.taxpolicycenter.org/briefing-book/key-elements/family/eitc.cfm); State EITC Online Resource Center (www.stateeitc.com/map/index.asp).

able 4. Proposed EITC legislation in California

Legislative session	Bill	Description
1999–2000	AB 1854	*Refundable* Earned Income Credit (EIC) equal to 15 percent of the federal EITC
1999–2000	SB 1421	
2000–2001	AB 106	
2003–2004	SB 224	
1999–2000	AB 2466	*Nonrefundable* EIC in an amount equal to an unspecified percentage of the federal EITC
2007–2008	AB 21	*Nonrefundable* state EITC equal to 4 percent of taxable income for low- and moderate-income taxpayers, up to maximum of $200 per year

NOTE: All of the EITC bills were introduced by Democratic legislators.

phased out as income rises. These adverse work incentives, plus the payment of EITC benefits to many workers who are employed anyway, parallel the potential problem of windfalls in hiring credit programs—that is, costs of the program that do not contribute to increased employment.

How Effective Are They?

Much of the empirical research on the EITC has focused on single mothers, for whom this program is most likely to increase employment. The evidence is overwhelming that, as predicted by theory, a higher EITC increases employment for this group. Most of this evidence focuses on the federal EITC, although some of it also comes from evidence on state supplements to the federal program.[23]

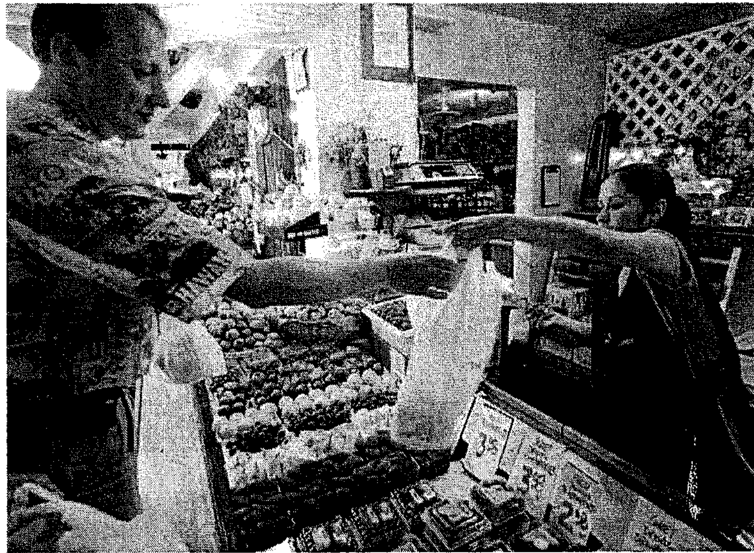
Studies have also examined labor supply effects among those already working and, in particular, secondary workers in families. The evidence is generally consistent with the prediction that work will decrease among these groups, although estimates vary from no effect to sizable effects.[24]

Many studies have evaluated the effects of the 1993 expansion of the federal EITC. These studies suggest that this policy change raised the employment rate of low-skilled single mothers by 18 to 23 percentage points (Ellwood 2000) and the employment rate of single mothers overall by about 6 to 7 percentage points (Meyer and Rosenbaum 2001).[25] In contrast, the employment rate of less-educated married men increased very slightly, and the employment rate of less-educated married women declined by just over 1 percentage point (Eissa and Hoynes 2004).

Paralleling the literature on the federal EITC, evidence on state EITCs finds that the strongest and largest effects are the positive effects on the employment of single mothers (Neumark and Wascher forthcoming). Further, there is no evidence that the state EITCs reduced the employment or hours worked of married women, although there are negative consequences for other groups who compete with single mothers for employment.

It is more difficult to estimate the overall effects of the EITC on labor supply. Research indicates that, on net, the EITC increases the total number of hours worked.[26] Some find that when the federal EITC expanded sharply between 1993 and 1998, weeks worked among single women with children rose substantially relative to married women with children and single women without children (Blank, Card, and Robins 2000). This evidence is not only consistent with the positive employment effects for single mothers noted above but also suggests that, for women, the net effect of the EITC on the total amount of labor supplied to the market is positive, with the increased number of work weeks associated with positive employment effects among single mothers outweighing any reductions in hours among those who were already working.[27]

Overall, then, there is a fairly strong consensus that the EITC has positive job creation effects—increasing the *number* of people employed. If that is the main or the only goal of policy, then the reductions in the number of hours worked of those already employed may be regarded as unimportant. However, the combined evidence suggests



DAMIAN DOVARGANES/ASSOCIATED PRESS

The main beneficiaries of the EITC are low-skilled single mothers and their families.

that even if these reductions in hours are taken into account, the EITC increases the total amount of labor supplied to the market. And although the direct evidence on state EITCs is more sparse, it appears that this conclusion applies at least as strongly to the state EITCs as to the federal EITC.

The EITC has the added benefits—from most peoples' perspective—of raising the incomes of poor and low-income families.[28] But recent research has highlighted some potential negative consequences of the EITC for other groups. Because the employment-increasing effects of the EITC for some groups increase competition with those already in the labor market, the EITC can reduce the income and employment of low-skilled workers ineligible for the EITC.[29] However, evidence on the effects of state EITCs suggests that the positive employment effect for less-educated single mothers with children is about six times as large as the negative employment effect for less-educated childless individuals and about 2.4 times as large as the negative employment effect for less-educated childless blacks and Hispanics.[30] These negative consequences for workers who compete with the main beneficiaries of this policy need to be included when weighing the costs and benefits of the EITC but, overall, the positive effects far outweigh the negative.

In sum, worker subsidies in the form of an EITC have two benefits. They induce people to take jobs, which increases employment. And in so doing, these subsidies increase the incomes of poor and low-income families. However, as the next section discusses, these conclusions do not imply that worker subsidies are necessarily preferable to hiring credits as a job creation strategy, especially for the short-term policy goal of helping California recover from the recent recession.

Hiring Credits Versus Worker Subsidies

As already explained, both hiring credits and worker subsidies can spur job creation.[31] The evidence generally suggests that both policies accomplish this goal. This section synthesizes the existing evidence to consider the arguments in favor of each policy. This discussion suggests that determining which policy is preferable may depend on what is considered: the short-term response to the recession and its aftermath or long-term efforts to increase employment and reduce unemployment. Finally, it summarizes what we know about the cost-effectiveness of the two policies in creating jobs—that is, the cost per job created.

Reasons to Favor Worker Subsidies

Worker subsidies have the advantage of avoiding the stigma effects and administrative costs of hiring credits. The EITC does not have stigma effects because, in contrast to hiring credits, employers typically have no idea that an employee is eligible for the EITC. And the EITC is easily administered through the tax code.[32] A state EITC is particularly simple when it "piggybacks" on the federal EITC calculation from the federal tax return, as most state EITCs do. This is reflected in state EITC tax forms, which just require a few items from the federal tax form and the federal EITC calculation.[33] In contrast, states have chosen very heterogeneous hiring credits, and there appear to be no state hiring credit programs that supplement federal credits in a simple way. Instead, employers have to certify

igibility for credits with state tax authorities, likely entailing substantial administrative costs.

Worker subsidies like the EITC also have better effects in terms of helping poor and low-income families. The one other existing study that presents a thorough comparison of worker subsidies and hiring credits emphasizes the beneficial effects of the EITC on the income distribution (Dickert-Conlin and Holtz-Eakin 2000, p. 269). This study also comes down on the side of using worker subsidies for job creation. However, this conclusion is based on evidence on the effects of hiring credits on the employment of disadvantaged workers, for which, as discussed above, hiring credits are quite ineffective. The evidence suggests that a noncategorical hiring credit such as the NJTC—focused more on the unemployed in general rather than on disadvantaged workers, and created to respond to a recession—has greater potential to create jobs.

Reasons to Favor Hiring Credits

Despite the disadvantages of hiring credits discussed above, they may be a more effective job creation policy than worker subsidies—at least in the short term. During a recession, the overriding concern of policymakers is surely putting more people back to work and lowering the unemployment rate. As a result, any state effort to enhance or broaden hiring credits would (or at least should) focus on the unemployed rather than on specific disadvantaged groups. A hiring credit focused broadly on the unemployed could substantially mitigate the stigma effects and administrative costs that have diluted the effectiveness of past hiring credit programs.

First, stigma effects would likely be less severe with a broad-based hiring credit. To illustrate: A hiring credit for ex-felons may reduce the cost of hiring ex-felons relative to other workers, but by signaling ex-felon status it may reduce employment for this group. In contrast, with national unemployment hovering near 10 percent (12% in California), eligibility for a hiring credit based on current unemployment may not send employers much of a bad signal—everyone understands that many people have become unemployed in the current downturn through no fault of their own.

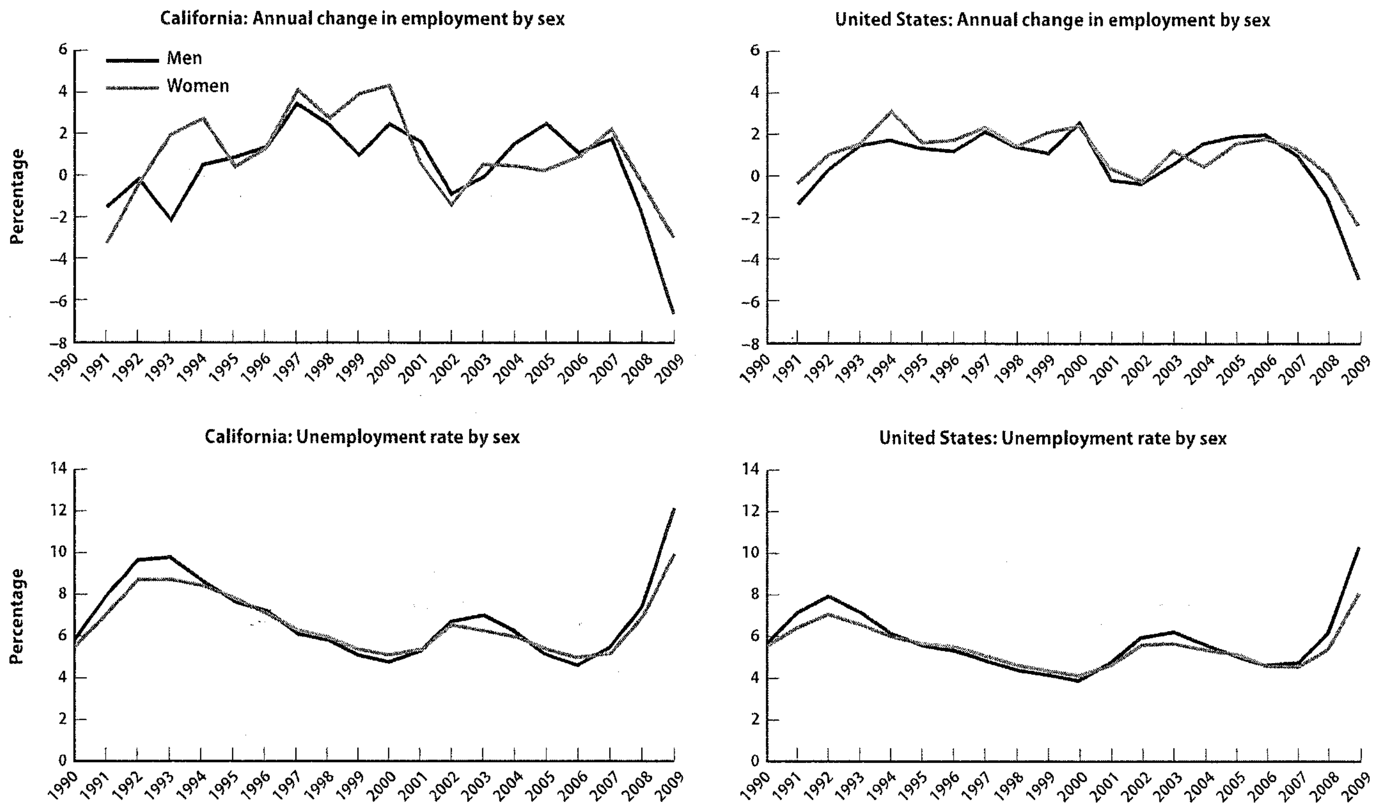
Second, in a period when employment has largely been falling (and is now growing slowly), it should be easier to reward hiring that would not have occurred but for the credit, reducing windfalls for firms that would be hiring anyway.[34] For example, in the current environment, basing eligibility simply on whether a firm's employment is growing might pose acceptable windfall costs, and such a simple rule for establishing eligibility would impose smaller costs on firms, making the credit more effective. Similarly, a credit targeting the recently unemployed should be administratively simple, as it is easy to verify unemployment status.

A hiring credit focused broadly on the unemployed could substantially mitigate the stigma effects and administrative costs that have diluted the effectiveness of past hiring credit programs.

Third, although worker subsidies allow for the greater concentration of benefits on poor and low-income families, in the near term such priorities may merit less emphasis. Policies—such as the EITC—that aim in part to redistribute income to low-income families focus attention on female-headed families with children, which are vastly overrepresented among the poor. However, the recent recession has had substantially greater adverse effects on men than on women. In both California and the United States, employment growth slowed and the unemployment rate rose much more sharply for men than for women after 2007 (Figure 2).[35] This suggests that a state EITC would do little to help the group most hurt by the recent recession. Thus, in the near term, a policy that redirects more of the benefits toward men may be called for. A hiring credit—and in particular one focused on the unemployed—would do this.

Finally, for meeting short-term goals, economic theory likely favors hiring credits over an expanded EITC. The discussion above of the effects of hiring credits and worker

Figure 2. The recession has hurt men more than women



SOURCE: Bureau of Labor Statistics, Current Population Survey, Annual Averages.

subsidies is premised on labor markets "clearing," meaning that employment and wages are determined by the intersection of labor supply and demand. But labor markets may not clear during recessions. Among economists, the more widely held view of recessions—and certainly of the recent downturn—is that they are caused when aggregate demand in the economy declines and wages do not fall to clear the labor market. In this case, increasing labor supply, as an EITC would do, does nothing to increase employment; if wages cannot adjust downward, then increasing labor supply does not lower wages paid by employers, so employers do not increase hiring.[36] Hiring credits, by helping to increase the demand for labor, would be more effective than worker subsides in this scenario.[37]

These arguments favoring hiring credits over worker subsidies are more germane to the short-term response to the recession. In normal times, policymakers might be more inclined to use hiring credits to target the disadvantaged rather than the unemployed more generally—targeting that makes hiring credits less effective. In addition, with the recovery of industries in which men are overrepresented, policymakers would likely be more inclined to refocus attention on assuring adequate income for female-headed households with children. And finally, with labor market equilibrium restored, and both aggregate labor demand and labor supply determining employment, the relative effectiveness of worker subsidies would likely increase.

How Much Do These Policies Cost?

Whether either policy is worth pursuing—and, if so, which one—hinges in part on the cost per job created.

ot surprisingly, it is very difficult to estimate these costs. And there is no information available on how they might differ in the current environment—with very high unemployment—and in the long term. The cost estimates summarized here are more the result of assumptions and back-of-the-envelope calculations than rigorous evidence. As such, they can at best provide only a rough guide.

Hiring credits. It is easy to measure dollars paid out in hiring credits. But calculating costs per job created requires knowing the effects of the credit on job creation. Even a hiring credit program deemed particularly effective at creating jobs is estimated to have paid out 92 percent of credits for jobs that would have been created anyway, and the more typical figure may be 96 percent (Bartik and Erickcek 2010). The implication is that the cost per job created under a hiring credit is much higher than the value of the credit paid out when an eligible worker is hired. Of course, that does not mean that the costs of hiring credits are necessarily prohibitive. The $3,000 credit under California's NJC might have to be multiplied by 10 or more to get the cost per job created, suggesting a cost of $30,000 or more to create a job.

But this may by a cost policymakers are willing to pay, and it may be cheaper than the cost of creating jobs via other policies. Most important, perhaps, the jobs created may deliver other benefits from stimulating the economy and allowing workers to remain employed and retain their skills. Although no one claims that the full costs can be recouped—or that a hiring credit (or other policy) pays for itself—these benefits do lower the net cost of the policy. Finally, as suggested above, in a high unemployment economy, the "wastage" or "windfalls" associated with hiring credits may be reduced, because it is easy to create incentives that reward only new hiring.[38]

Taking these considerations into account, the range of estimates for costs per job created using a hiring credit range from about $9,100 to $75,000, and there are reasons to believe that the upper range of these cost estimates could be quite a bit lower (perhaps by one-half or more) for a hiring credit sharply focused on the recently unemployed and used during a period in which unemployment remains inordinately high.[39]

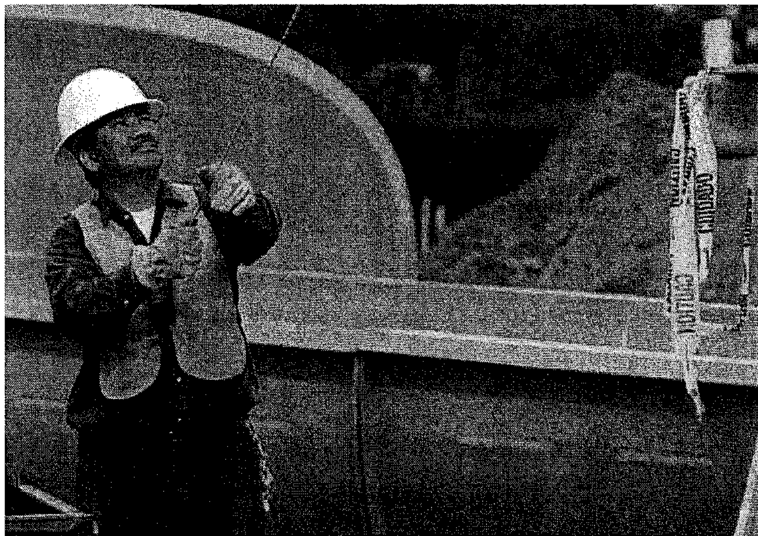
Worker subsidies. Because of the potentially large groups of people who do not increase their employment, and may even decrease employment in response to an EITC, estimated costs per job created are typically higher, but the range of costs is also wider. Based on evidence from the effects of both the federal EITC and state EITCs, the range of estimates is from about $12,000 to $207,000, with a larger body of evidence suggesting a somewhat narrower range of $50,000 to $117,000.

Costs in perspective. These estimates of costs per job created by either hiring credits or worker subsidies ignore some other potential benefits and hence should be viewed as estimates of gross rather than net costs per job created. In other words, these policies likely deliver some benefits that—either directly or indirectly—imply that the policies *in part* pay for themselves. The net costs of either type of policy would be lower to the extent that the added employment from a hiring credit reduces other government expenditures (such as unemployment insurance or welfare benefits) or increases tax receipts. These cost savings are likely to be only a fraction of the cost per job created described above—but likely not a trivial fraction. There also may be long-term benefits to keeping people employed and off public benefits, although these are hard to estimate.[40] Costs could also be lowered if increased employment from a hiring credit or a worker subsidy leads to stimulative effects on the economy.[41] Of course, either policy would be financed by taxes, which reduce someone else's income. But to the extent that such a policy transfers income to those who spend a higher share of their income on current consumption (a higher "marginal propensity to consume out of income"), they could have stimulative effects leading to additional government revenue.

These policies likely deliver some benefits that—either directly or indirectly—imply that the policies *in part* pay for themselves.

Given the tremendous uncertainty associated with these effects, it is not possible to pin down how much lower than gross costs the net costs of these policies would be—although clearly they would be lower. Gross costs could overstate many-fold the net costs once these other offsets are taken into account. For instance, some research on hiring credits has estimated the net cost per job created to be $4,700 to $6,300—based on estimates of a fairly high success rate in creating jobs, along with estimates of extra gross domestic product (GDP) and hence higher government revenues and lower government expenditures that would be created by a hiring credit.[42] Even if these estimates were two to four times higher—which might be more plausible—they would still be well below some of the gross cost figures cited above.

Despite the uncertainty, perhaps the most important lesson is that the cost of creating jobs with an EITC, in particular, *could* be very high. As a pure job creation strategy intended to counter the recent recession, then, the EITC is likely to be inferior to a hiring credit. This conclusion should be tempered, however, because there is simply less rigorous evidence on the effects of hiring credits on employment, and some of the cost estimates of hiring credits are based on strong conclusions about the success of an anti-recessionary hiring credit program from the 1970s that may not be justified.



SANDY HUFFAKER/CORBIS

Hiring credits could spur job creation in male-dominated industries (like construction) that were hit hard by the recession.

How Much Impact Could Direct Job Creation Policies Have?

As the discussion of costs presented above suggests, implementing direct job creation policies requires considerable government investment. How many jobs would these policies yield in California—and how much would the state need to spend? Can California significantly alter the effect of the recession—especially given its ongoing budget woes? To gain some perspective on these questions, this section examines recent federal efforts to counter the recession and estimates what kind of effect state spending—particularly through a hiring credit program—might have on the labor market.

Federal efforts to counter the recession, and the cost per job of these efforts, shed some light on the relative magnitudes of the effects of federal spending compared to the potential effects of direct job creation policies. The Congressional Budget Office (CBO 2010) estimates that, as of the end of the second quarter of fiscal year 2010 (September 2010), $570 billion of the total American Recovery and Reinvestment Act stimulus funding will have been spent. It also estimates that, as of that same quarter, employment was higher than it would have been without this spending by 1.4 to 3.6 million jobs. Measured this way, these figures imply costs per job created of $158,000 to $407,000.[43] Other studies of the recent stimulus spending have found lower costs per job, but for the purposes of this report the CBO numbers are most useful.[44]

Before comparing the job creation costs of the stimulus to those of hiring credits or worker subsidies, we should briefly consider how long jobs last.[45] If new jobs were going to last one year rather than one week, we would presumably place more value on a higher employment level at a point in time. To the extent that jobs created by the stimulus are relatively short-term, these jobs might be viewed as less valuable—at least compared to those normally produced by the private sector.[46] However, given that low-

killed workers have much higher unemployment rates than high-skilled workers, it is probably best to think about the stimulus as mainly targeting sets of workers similar to those targeted by hiring credits and worker subsidies, at least when hiring credits focus on the unemployed. The jobs created might then be thought of as lasting as long as jobs typically last for the relatively low-skilled, implying that this consideration would not influence comparisons of the costs of creating jobs via the stimulus versus creating them with hiring credits or with worker subsidies.

How does the cost of creating jobs through the federal stimulus compare with the costs of hiring credits or worker subsidies? The discussion in the previous section suggested that the range of estimates per job created using worker subsidies is $12,000 to $207,000, and the range for hiring credits focused on the unemployed is $9,100 to $75,000 and perhaps much lower if we take account of multiplier effects (which the CBO estimate does). These ranges suggest that it is very likely that the costs of creating jobs via hiring credits are *much* lower than the costs of creating jobs via the federal stimulus.[47] This is likely also the case for worker subsidies, although here the ranges overlap, making this comparison less clear unless one is confident that the costs of job creation via worker subsidies are at the lower end of the range of estimates provided above.

These comparisons might suggest that California could do a lot more to create jobs than the federal stimulus could—especially through hiring credits. However, the fiscal resources of the federal government, because of its ability to borrow vast sums, far outweigh the fiscal resources of the state government. This is true even in the best of times, let alone during California's current budgetary difficulties.

To put the federal role in perspective, let us assume that the range of job creation effects of the stimulus was distributed to California in proportion to its population (12%). This puts the range of federal job creation, at a point in time, at 168,000 to 396,000. Using these estimates, and assuming no other changes, the implication is that without the federal stimulus, California's unemployment rate (in November 2010) would have ranged from 13.3 percent to 14.6 percent, instead of the actual rate of 12.4 percent.[48]

It is very likely that the costs of creating jobs via hiring credits are *much* lower than the costs of creating jobs via the federal stimulus.

But these federal efforts are costly. Assuming that the federal stimulus funds spent so far ($570 billion) were also distributed in proportion to California's 12 percent share of the U.S. population, California would have received $68 billion of the stimulus. Based on midpoints of the estimated costs per job created through each policy, costs break down accordingly: $290,000 per job via stimulus spending, $110,000 via worker subsidies, and $42,000 via hiring credits. That is, hiring credits—which appear most effective—are about 6.9 times more effective than stimulus spending.

A state hiring credit program would be costly, too. For California to get a job creation effect equivalent to that of the federal stimulus, the state would have had to spend a total $9.9 billion (the estimated federal stimulus spending in California, divided by 6.9). There is likely no possibility of spending anything near that amount.

More realistically, suppose that the state spent one-tenth of this amount, or approximately $1 billion. Using the midpoint of the hiring credit estimates of costs per job created ($42,000), this would lead to about 24,000 more jobs, which would lower the (November 2010) 12.4 percent unemployment rate to 12.26 percent, a decline of less than two-tenths of a percentage point. If we instead took the low estimate of the cost of creating jobs via hiring credits, then the spending of $1 billion would create 110,000 jobs, lowering the unemployment rate to 11.8 percent, or a decline of six-tenths of a percentage point.

What these calculations illustrate is that, even under the rosiest scenario (a low estimate of the cost of creating jobs via hiring credits), the state's ability to significantly affect the labor market is limited. A more cautious view of those costs only reinforces this conclusion. This does not imply that an aggressive pursuit of job creation through a policy of hiring credits (or even worker subsidies) is not worthwhile. But there should be no illusion that these policies can do

anything but partially mitigate the effect of the recession. The ability of federal policy to counter the cycle is far greater, and, of course, the ability of the economy itself to create jobs, as it recovers, swamps the effects of either state or federal policy.

Making Hiring Credits or Worker Subsidies More Effective

This analysis of hiring credits and worker subsidies would not be complete without some consideration of the implementation details of each policy.[49] The research literature and some recent proposals point to ways to make both hiring credits and worker subsidies more effective. This section summarizes the most important points, including proposals for lowering costs.

With regard to hiring credits, the research suggests a number of areas of improvement. First, to reduce windfalls, spending on credits can be concentrated during and soon after recessionary periods, when, because job growth is low (or negative), fewer firms would likely be experiencing employment growth absent the hiring credit. Second, hiring credits should be short-term and temporary to shift hiring *into* the period in which job growth is subpar. Third, avoiding retroactive filing for hiring credits will probably increase the likelihood that payments go for hiring that was induced by the credit, rather than paying firms for past hiring unrelated to the credit. Fourth, hiring credits should create explicit incentives for growth in employment, rather than hours worked, to minimize costs per job created.[50] For example, California's NJC explicitly targets full-time workers.[51] Finally, there is a natural tendency for business groups to push to expand eligibility for any hiring credit, providing broader tax relief for businesses rather than targeting the policy explicitly on job creation.[52] Thus, it is important to implement a hiring credit that keeps the focus on new job creation.

There are a number of proposals to reduce the costs of worker subsidies. These include ideas for structuring state EITCs differently and reducing costs per job created by improving targeting. Federal EITC payments go to families well above the poverty line, to avoid phasing out benefits too quickly. In addition, individuals with high wages but low hours worked may be eligible for the EITC, because it is based on income during the year, but there is little rationale for policies to transfer income to high-wage individuals.[53] To address these problems, one proposal suggests a "wage-based" EITC that pays higher benefits the higher the share of full-time work in a family (MaCurdy 2004). A wage-based EITC could provide similar incentives and benefits for low-wage workers and greater work incentives for high-wage workers, while lowering program expenses by reducing benefits for families with high-wage and part-time workers. A drawback to this alternative is that it poses greater administrative challenges than would a simple supplement to the federal EITC.

Another possibility is to use a more narrowly targeted version of an EITC. For example, the Self-Sufficiency Project (SSP) in Canada focused on long-term welfare recipients and imposed a minimum work requirement of 30 hours per week, both of which should have vastly reduced the number of people who received the benefit without changing their behavior. Indeed, about one in two of those receiving SSP benefits enter employment because of the program, whereas for EITC, the ratio is about one in 20 (Bartik 2001). Clearly, a sizable increase in the ratio of the number of beneficiaries who change their behavior relative to the number who simply get the benefits of the program without changing their behavior could result in radically lower costs per job created than some of the estimates for the EITC discussed above.

Finally, a state (or local) EITC may have a larger effect than might be suggested simply by the dollar amounts of the state EITC benefits. In particular, we know that EITC take-up is high but below 100 percent (80 to 86% according to Scholz 1994). It is possible that a state EITC induces some of those eligible for the federal EITC to take it up, thus increasing the incentive effects of the federal program at relatively low cost. Indeed San Francisco's EITC (Working Families Credit) was explicitly intended to boost participation in the federal EITC, in part by publicizing the federal EITC and in part by increasing the incentive to apply for the federal EITC. (There is, as yet, no evaluation of whether the program increased take-up.)[54]

'olicy Recommendations

California faces high unemployment and weak job growth as a result of the recent recession. But California also has a long-term unemployment problem. In assessing hiring credits and worker subsidies, short- and long-term considerations play an important role. In the short term, when the problem is extraordinarily high unemployment, it is likely that hiring credits would have larger employment effects than worker subsidies, with lower (and possibly much lower) costs per job created. Given the state's budget crisis, the criterion of cost per job created is obviously central. In addition, hiring credits are likely to be more effective at increasing the employment of those recently unemployed than are worker subsidies. And, finally, hiring credits are likely more effective during an economic downturn. Thus, for addressing job creation in the short term, hiring credits are probably the best policy choice.

In the long term, however, other considerations come ɔ the fore. These include the greater certainty regarding ιhe effects of worker subsidies, the re-emergence of greater interest in the income distribution and other policy concerns as the economy recovers, and the lower effectiveness of hiring credits in increasing the employment of the "hard-to-employ." As a consequence, worker subsidies in the form of a state EITC should, in the long term, figure more prominently in the state's arsenal of job creation policies.

It is important to keep in mind that this report considers only the evidence on *direct* job creation policies: hiring credits and worker subsidies. The possibility that some indirect policy is more effective has not been completely ruled out or tested, based on a thorough review of the evidence. Nonetheless, with an appropriate understanding of this potential limitation, some specific policy recommendations regarding job creation policies emerge:

- In the short run, if state policymakers want to spend money on job creation, they should use hiring credits—while understanding that the effects are likely to be positive but modest relative to the overall effects of the recession and that the costs of countering the recession through hiring credits are high.
- To be most cost-effective, a hiring credit should focus on the recently unemployed. It should create incentives for new employment rather than increases in the work hours of existing employees. And it should use simple rules and a relatively low hurdle for employers to claim the credit. The state's current New Jobs Credit may well be too limiting: It does not target the recently unemployed specifically, it applies only to small firms, and the credit may be too low (at least relative to the current-dollar equivalent of the federal New Jobs Tax Credit used in the 1970s).
- In the long term (that is, when the state's economy and budget situation improve), California should give serious consideration to establishing a worker subsidy program in the form of a state EITC.
- The state might best follow many other states and specify the EITC as an add-on to the federal EITC. However, there is merit to considering an EITC that rewards full-time work, perhaps by imposing minimum hours requirements, so as to enhance the employment effects.
- To be better prepared to counter future recessions—which *will* occur—California should enact a hiring credit that remains on the books permanently but that more aggressively rewards the hiring of unemployed workers during economic downturns, and "turns off" during better economic times.

As we have seen, neither hiring credits nor worker subsidies could, at any plausible level of spending, make more than a modest dent in countering the lingering labor market effects of the recent recession. But there is a good chance that a hiring credit could make that dent at a moderate cost.

Perhaps the most important policy recommendations here concern planning for a time when the state's finances are improved—but before the next recession hits, as it inevitably will. Looking ahead, there are good reasons for the state to enact its own EITC—as many other states have done. And establishing a hiring credit program that kicks in automatically when the economy does slow down can at least cushion the state against the type of blow it has suffered recently. ●

Notes

[1] The higher unemployment rate in California is not attributable to demographic differences between California and the rest of the country. (Of course, even if it were, that would not imply that the state should not consider policies to increase employment and lower the unemployment rate.) California's population includes a much higher share of Hispanics, a somewhat lower share of blacks, a lower share of whites, and a higher share of Asians. The unemployment rate differential appears for each group and is in fact largest for whites. If the U.S.-California gap were attributable instead to California's having a higher representation of groups with high unemployment rates, there would be no unemployment gap for these separate groups. The conclusion that demographics do not account for California's higher unemployment rate was confirmed by a regression analysis using Current Population Survey Outgoing Rotation Group files for 1992–2007, which showed that the probability that a labor force participant was unemployed was higher in California than in other states and that this gap was not reduced by accounting for race, ethnicity, age, or education.

[2] When hiring credits are designed to encourage job creation—that is, net new hiring—they are sometimes referred to as "job creation tax credits." This report uses the more generic label "hiring credit" but emphasizes the importance of designing hiring credits to encourage new hiring, rather than simply subsidizing hiring that would have occurred without the credit.

[3] One form of direct job creation policy that is not covered in this report is increases in direct employment by the public sector. Public employment is expensive. Although hiring credits and worker subsidies try to spur job creation by changing the marginal cost of, or marginal return to, work, public employment requires paying the entire cost of employing the worker. This may well explain why there is no movement toward creating public sector jobs—in California or at the federal level—as part of either a short-term response to the recession or a long-term employment strategy, with the exception of youth programs. This contrasts with hiring credits and worker subsidies, both of which are used extensively at the federal and state levels, and both of which are or have been the focus of recent proposals in California.

[4] The list of proposed policies is far more extensive. See http://arc.asm.ca.gov/cajobs/?p=solutions, http://cssrc.us/publications.aspx?id=7554, http://senweb03.sen.ca.gov/focus/agenda2010/legislation.aspx, www.calchamber.com/governmentrelations/pages/jobcreators.aspx, and http://images.emaildirect.com/clients/govpressoffice847/SOTSJobsandEconomyPackage.pdf. One might also add training and workforce preparation to the list. However, much of the return to training and education comes in the form of higher wages for those employed—a worthy goal but not one directly related to job creation. The training literature is vast. For a thorough review focused on training programs that increase employment, see LaLonde (2003) and Card, Kluve, and Weber (2010).

[5] Moreover, even some proposals to reduce *labor* costs could actually reduce employment, if they do not reduce costs on the margin that affects hiring. For example, changing overtime rules to apply after a 40-hour week rather than an 8-hour day (as is currently done in California) could reduce employment and increase the hours worked of those employed, because such a policy change makes it relatively cheaper to have the same workers work longer days. See Hamermesh and Trejo (2000).

[6] Nonetheless, the NJTC created stronger incentives to hire low-wage workers by applying only to the first $4,200 of wages per employee (in 1977 and 1978).

[7] Indeed, although not detailed in the table, some states have provisions to "recapture" some of the tax credit if net job creation falls below the targets for which credits were received.

[8] There is a cumulative spending cap of $400 million for this credit; after the cap is reached, the credit will be discontinued (www.ftb.ca.gov/aboutftb/Tax_Expenditure_Report_2009.pdf), implying that the credit is temporary. However, claims thus far total less than one-tenth of this amount (www.ftb.ca.gov/businesses/New_Jobs_Credit.shtml).

[9] These are discussed fully in Dickert-Conlin and Holtz-Eakin (2000) and Katz (1998).

[10] See, for example, Bartik and Erickcek (2010).

[11] Moreover, efforts to avoid windfalls can lead to unintended consequences that reduce job creation. For example, paying credits for new hires creates incentives for repeatedly firing some workers and hiring others to collect the credit; this "churning" does not increase employment. And even if policy avoids rewarding the simultaneous hiring and firing of workers at a particular business establishment, it may be harder to prevent churning in the form of hiring at some establishments belonging to a firm and firing at other establishments. On the other hand, efforts to reduce churning (at the establishment or firm level) by paying the credit only for job growth in excess of estimated job growth absent the credit is administratively expensive and likely unreliable. Moreover, this type of policy design can reward variation

employment, since employment increases are rewarded but employment decreases are not penalized.

[12] Despite the many state hiring credit programs in existence (partially documented in Table 1), the existing research is nearly exclusively about federal programs, and there is very little empirical research evaluating the effectiveness of these state policies. One exception is Bartik and Erickcek's (2010) evaluation of the Michigan Economic Growth Authority Tax Credit Program. This is a strongly favorable evaluation, although two qualifications are in order. First, the program is quite different from other hiring credit programs. It is discretionary (in that the responsible agency evaluates the particular proposal in light of its potential benefits and costs), it is focused on a subset of industries (mainly manufacturing), and it pays credits for a very long period (up to 20 years). Second, the evaluation is not based on the kind of before-and-after analysis that typifies most research analyzing public policy and is instead based on a simulation model that takes many parameters from the existing literature. In addition, there are some evaluations of small-scale hiring credit (or "voucher") experiments, discussed below. Finally, a very recent and preliminary paper (Chirinko and Wilson 2010) estimates the effects of state hiring credits, finding some modest evidence of positive effects.

The NJTC was claimed for 50 percent of eligible hires, whereas ates on the order of 10–20 percent were claimed for hiring credits more focused on the disadvantaged (Bartik 2001; Hamersma 2005).

[14] There is similar evidence from another randomized experiment discussed in Hollenbeck and Willke (1991).

[15] See Bloom et al. (1994), Farkas et al. (1984), Gueron and Pauly (1991), Hamersma (2008), and Katz (1998). Bartik (2001, Ch. 1) suggests that these other efforts in support of hiring credit programs may be the mechanism that helps to overcome stigma effects, by providing information to employers that the workers are more productive than their "stigmatizing characteristics" might suggest.

[16] See Dickert-Conlin and Holtz-Eakin (2000).

[17] The NJTC attempted to create incentives for new hiring in a simple way—by paying the credit for firms in which employment increased by more than 2 percent. There was also a maximum credit of $100,000 per firm.

[18] Bishop (1981) suggests that these industries may be particularly sensitive to hiring credits, because capital equipment depre-ates quickly and labor turnover is high.

[19] Perloff and Wachter (1979) conclude that "the New Jobs Tax Credit may have shifted the distribution of the rate of growth of employment" (p. 178). Bishop (1981) is firmer in drawing conclusions but acknowledges that "Perhaps the NJTC variable is capturing other exogenous forces that are inducing contemporaneous employment increases . . . in the sectors studied" so that "the conclusion that NJTC is having major effects on employment and prices must remain tentative until better data or more periods of observation become available" (p. 240).

[20] Indeed, Bartik and Bishop have earlier described the evidence more cautiously. Bishop's (1981) reservations were noted in the previous footnote. And Bartik (2001) wrote that "The NJTC may have created as many as 700,000 new jobs" (p. 226), indicating that the 700,000 figure was an upper bound, a qualification Bartik and Bishop (2009) omit when they write "Formal evaluations suggest that the 1977–78 NJTC was quite successful, creating 700,000 jobs by February 1978 and probably many more by December 1978" (p. 9).

[21] "Without children" means that there are no children who qualify the family for the higher EITC payment; this is based on which parent the child lives with for how much of the tax year. Similarly, the text often refers to those without children as "ineligible" for the EITC, even though they can get a very small credit if they are between ages 25 and 64.

[22] Indeed, the main reason for the popularity and increasing generosity of the EITC in recent decades is probably this pro-work incentive that it generates, which, along with welfare reform, was intended to shift the nation's income-support policies toward those that encouraged, rather than discouraged, work (see Blank, Card, and Robins 2000).

[23] A partial listing of the relevant literature on the federal EITC includes Meyer and Rosenbaum (2001), Eissa and Liebman (1996), and Keane and Moffitt (1998). The only exception to the evidence of positive employment effects is Cancian and Levinson (2005), who do not find evidence that the increase in Wisconsin's EITC for families with three children increased the employment of single mothers in this group. Neumark and Wascher (forthcoming) study state EITCs. Extensive literature reviews of the effects of the EITC are provided in Hotz and Scholz (2003) and Hoffman and Seidman (2003).

[24] Key references are Eissa and Hoynes (2004), Eissa and Liebman (1996), and Hoffman and Seidman (2003).

[25] This expansion raised the phase-in rate for families with one child from 18.5 percent to 34 percent and for families with two

or more children from 19.5 percent to 40 percent. It also introduced the small credit for families with no children.

[26] See Keane and Moffitt (1998), Dickert, Houser, and Scholz (1995), and Meyer and Rosenbaum (2001) for estimates for women and Dickert, Houser, and Scholz (1995) for total estimates.

[27] It is unlikely that the EITC has much effect on married women without children. It may have adverse effects on single women without children who may be less skilled and who face increased competition from single women with children who are induced to enter the labor market because of the EITC.

[28] For example, Scholz and Levine (2001) report that over 60 percent of EITC benefits go to taxpayers in families below the poverty line. And Neumark and Wascher (2001, forthcoming) find that state EITCs—because of their positive labor supply effects—lead to more families earning their way out of poverty (or extreme poverty, defined as one-half the poverty line); with the additional income supplement from the EITC, they are made even better off. There is similar evidence from other worker subsidies discussed in Blank, Card, and Robins (2000), with family income rising by substantially more than cash assistance for the most effective programs.

[29] See Rothstein (2008), Leigh (2010), and Neumark and Wascher (forthcoming).

[30] The employment declines among the latter group are unlikely to be as large as the employment increases among single mothers, because those without children are likely to find even low-wage work more attractive than not working.

[31] In fact, in simple, stylized cases, for the same percentage subsidy to hiring or employment, the *quantitative* effects on employment (and wages) are predicted to be *identical*.

[32] There is a sizable potential cost to taxpayers as a whole, although not to employers per se, from overclaiming of the EITC when children are claimed on tax returns but did not reside with the filer for the one-half year required by law. Hoffman and Seidman (2003, Ch. 7) discuss evidence suggesting that little of the overclaiming is fraudulent and summarize policy changes to reduce overclaiming.

[33] For examples, see www.tax.state.ny.us/pdf/2009/fillin/inc/it215_2009_fill_in.pdf for New York, www.iowa.gov/tax/forms/1040AShortBooklet09.pdf for Iowa, and http://forms.marylandtaxes.com/current_forms/resident_booklet.pdf (p. 9) for Maryland.

[34] However, the ability to easily create incentives for new hiring just because unemployment is high should not be overstated. The U.S. Bureau of Labor Statistics Job Openings and Labor Turnover Survey shows that, even during a recession, there are a lot of firms doing a lot of hiring.

[35] This is attributable to substantial employment declines in industries with a large share of males, in particular construction and manufacturing, in which the combined employment decline was about as large as the overall decline (from 2006 to 2009).

[36] Nonetheless, because the EITC induces some people to enter the labor market, it may change the composition of who is employed and could therefore still achieve some of its income distribution goals.

[37] The converse is also true: When labor markets are much tighter and unemployment is low, hiring credits may be quite ineffective at increasing employment, resulting, instead, mainly in higher wages.

[38] This may be the rationale for the HIRE Act's focus on rewarding hiring of the unemployed or those entering or reentering the labor market.

[39] For both hiring credits and worker subsidies, a longer working paper (Neumark 2011) provides more detail on the sources of these estimates and some guidance as to which estimates within these ranges are more plausible.

[40] In particular, policies that keep more people employed during an economic slowdown may help preserve workers' skills, which can mean higher wages and higher employment down the road. There is evidence of this kind of effect (in the opposite direction), which documents long-run deleterious effects on employment from time out of the labor force, whether due to high minimum wages during one's youth (Neumark and Nizalova 2007) or to previous unemployment spells (Mroz and Savage 2006). With respect to hiring credits, some research also assesses how long-lasting the effects of the credits are on affected individuals. Some studies find persistent effects on individuals' employment and earnings but others do not (Katz 1998); in any event, the persistence is weak at best.

[41] Economists refer to such stimulative effects as "multipliers." If an unemployed person gains a job, that person spends part of his or her income at other firms, leading those firms to increase hiring, etc.

Bartik and Bishop (2009) estimate very large effects via this channel that offset more than 75 percent of a hiring credit that they propose. This is based on the assumption that each new job created generates an addition to GDP equal to the economy-wide average labor compensation ($62,000). This seems quite high. Surely the estimate is subject to a great deal of uncertainty; and it seems that the calculation should be based not on average compensation but instead on a lower level of compensation that might be more likely for the workers who benefit from hiring credits.

[43] The report also estimates full-time-equivalent jobs created, which can include the effects of converting part-time to full-time jobs. These estimates range from 2.0 to 5.2 million, implying costs per full-time-equivalent job of $110,000 to $285,000.

[44] For these alternative estimates, see Council of Economic Advisers (2009). There is some ambiguity regarding how to count the jobs created by the stimulus (putting aside issues of how to estimate these effects). Since jobs are not permanent, some jobs created by the stimulus would already have ended by September 2010, in which case these estimates of costs per job created by the stimulus are too high, because they divide the cost of the stimulus by the employment differential at a point in time and do not include jobs that were created but already ended. The CEA report tries to account for this issue by estimating job creation as the sum of the employment differentials in each quarter in the president's first term (which roughly coincides with the period in which the stimulus is expected to have an effect). This lowers the estimate of cost per job created. However, since the job creation effects of hiring credits and worker subsidies were calculated based on employment at a point in time, rather than on the cumulative effects over many periods, the best comparison to the job creation costs of the stimulus is with the CBO estimates.

[45] The CEA report may appear to address this issue by reporting "job-years" created by the stimulus. Indeed, the report says "A job-year means simply one job for one year" (Council of Economic Advisers 2009, p. 3). What job-years actually means in this context is the accumulated sum of the employment differential measured once per year—a calculation that still ignores job durations.

[46] As noted above, though, even if the jobs directly created by a policy are short term, they may lead to higher employment in the long term.

[47] Even the CEA document suggests that the cost per job created via government spending is $92,000 and the cost via cutting taxes or state fiscal relief is even higher (Council of Economic Advisers 2009).

[48] For the November 2010 numbers, see www.edd.ca.gov/About_EDD/pdf/urate201011.pdf. The assumption of no other changes is not completely realistic. Typically, when job growth strengthens, some people who had previously given up looking for work reenter the labor force and look for work, in which case the unemployment rate would decline by less than would be predicted simply by the growth in jobs. Nonetheless (and for this reason), growth in the number of jobs is a better gauge of economic recovery than is the change in the unemployment rate (see Kwok, Daly, and Hobjin 2010).

[49] The longer accompanying working paper (Neumark 2011) provides a lengthier discussion of policy considerations.

[50] And increasing employment rather than hours worked will do more to reduce expenditures on Unemployment Insurance.

[51] In contrast, Bartik and Bishop's (2009) proposal calls for a hiring credit that is simply a percentage of payroll, because, they argue, "We want to provide incentives for hours increases as well as net additions to employment" (p. 12).

[52] Lorenz (1995) discusses the case of the TJTC, which was intended to reduce windfalls (and to relieve the administrative burden on employers) by mandating ongoing program evaluation with reporting to Congress on the credit's effectiveness in increasing employment among targeted groups. Lorenz argues, however, that, via the oversight process, interest groups distorted the credit into "a windfall for businesses that hire large numbers of low wage workers" (p. 270).

[53] Better targeting could also reduce the labor supply disincentives associated with the EITC for high-income families that are still eligible (MaCurdy 2004).

[54] See Flacke and Wertheim (2006) for a discussion of the Working Families Tax Credit. See Avalos and Alley (2010) for information on unclaimed federal EITC payments in California.

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About the Author

David Neumark is a Bren Fellow at the Public Policy Institute of California, a professor of economics at the University of California, Irvine, a research associate of the National Bureau of Economic Research, and a research fellow at the Institute for the Study of Labor. He has published numerous studies and books on school-to-work programs, workplace segregation, sex discrimination, the economics of gender and the family, affirmative action, aging, minimum wages, and living wages. He is an associate editor of the *Review of Economics of the Household* and is on the editorial boards of *Industrial Relations*, *Contemporary Economic Policy*, the *Journal of Labor Research*, and the *Journal of Urban Economics*. He has also held positions as professor of economics at Michigan State University, assistant professor of economics at the University of Pennsylvania, and economist at the Federal Reserve Board. He holds a Ph.D. in economics from Harvard University.

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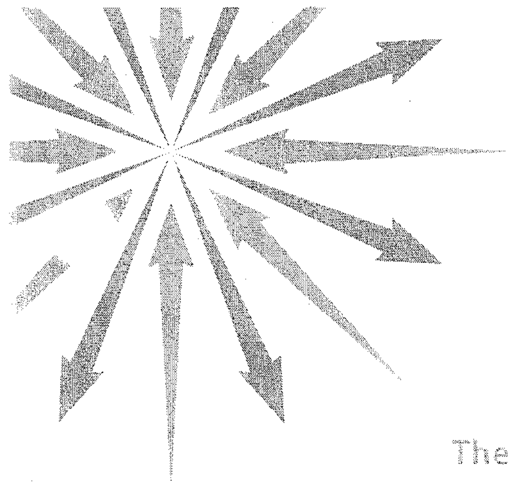

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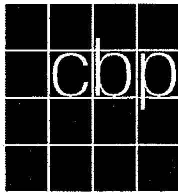


CALIFORNIA BUDGET PROJECT

policy points

FEBRUARY 2011

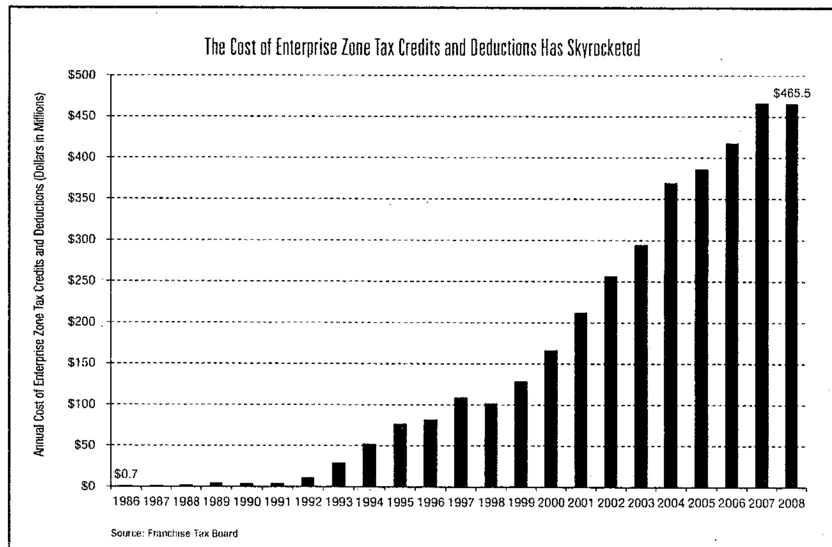
CALIFORNIA'S ENTERPRISE ZONE PROGRAM: NO BANG FOR THE BUCK

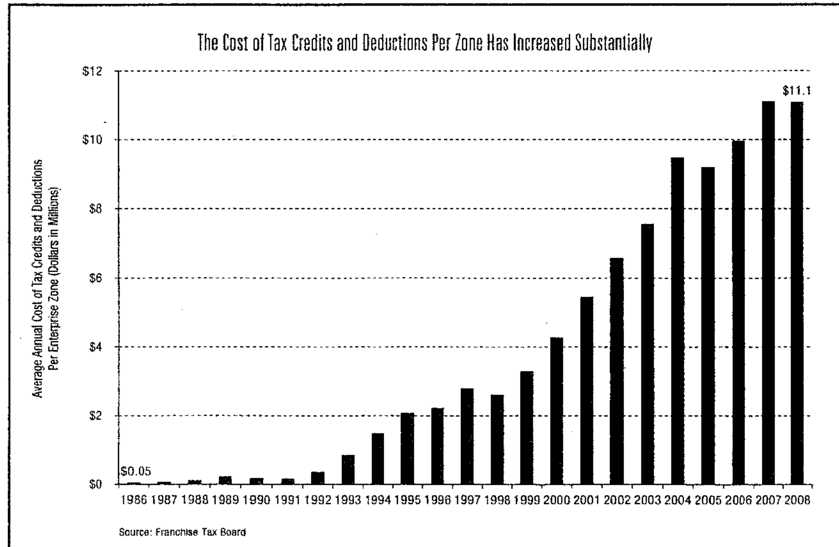
As part of his Proposed 2011-12 Budget, Governor Brown called for the elimination of tax breaks provided through California's Enterprise Zone (EZ) Program and other geographically targeted programs.[1] This proposal would generate an estimated $343 million in 2010-11, $581 million in 2011-12, and more than $600 million each year thereafter. The Legislative Analyst's Office (LAO) has recommended for years that the state eliminate or restructure EZs "because they are expensive and not strongly effective."[2] Indeed, the best available independent research finds that the state's EZ Program fails to create jobs or new businesses – key goals of the program. Yet EZ tax breaks have cost the state $3.6 billion since the program's inception, primarily benefiting less than half of 1 percent of the state's corporations – those with assets of $1 billion or more.

KEY FACTS

- **The cost of EZ tax credits and deductions has increased substantially since the beginning of the EZ Program.**

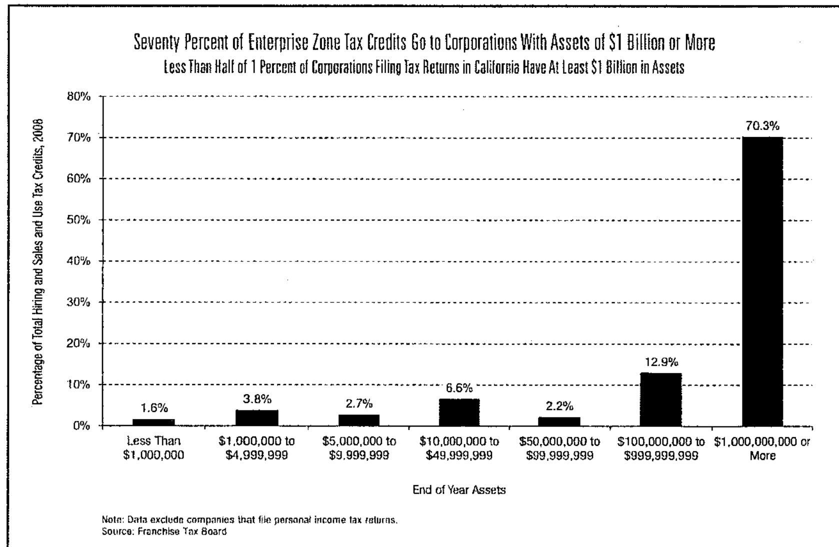
EZs cost the state $465.5 million in 2008, up from just $675,000 in 1986.[3] In fact, the cost of EZ tax credits and deductions has increased by 35 percent *per year,* on average, since the program's inception, for a total cost to the state of $3.6 billion. The average cost per zone has also increased substantially, from approximately $48,000 in 1986 to $11.1 million in 2008, reflecting increased use of EZ tax breaks.

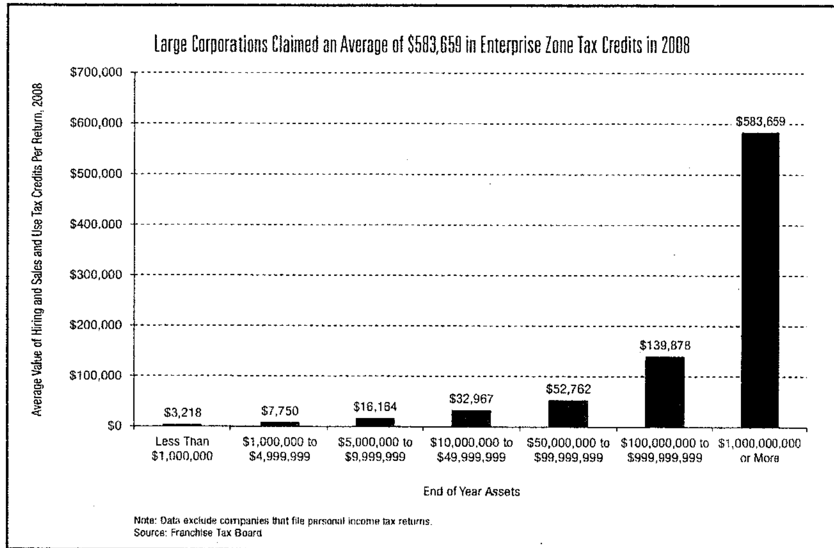




- **Very large corporations claim most of the EZ tax breaks.**

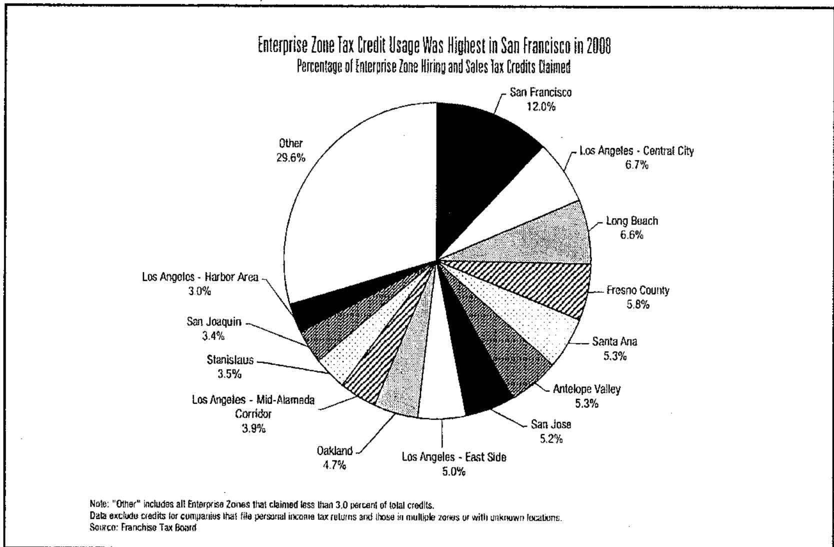
Corporations with assets of $1 billion or more claimed 70.3 percent of the total dollar value of EZ tax credits claimed by corporations in 2008, even though less than half of 1 percent of corporations that file tax returns in California have assets of $1 billion or more.[4] Nearly all of the tax credits (91.9 percent) were claimed by corporations with assets of $10 million or more, while corporations with less than $1 million in assets claimed only 1.6 percent of EZ tax credits. Thus, small businesses are not a major beneficiary of EZ tax breaks. Corporations with assets of $1 billion or more claimed an average of $583,659 in EZ tax credits in 2008, compared to $3,218 for corporations with assets of less than $1 million.





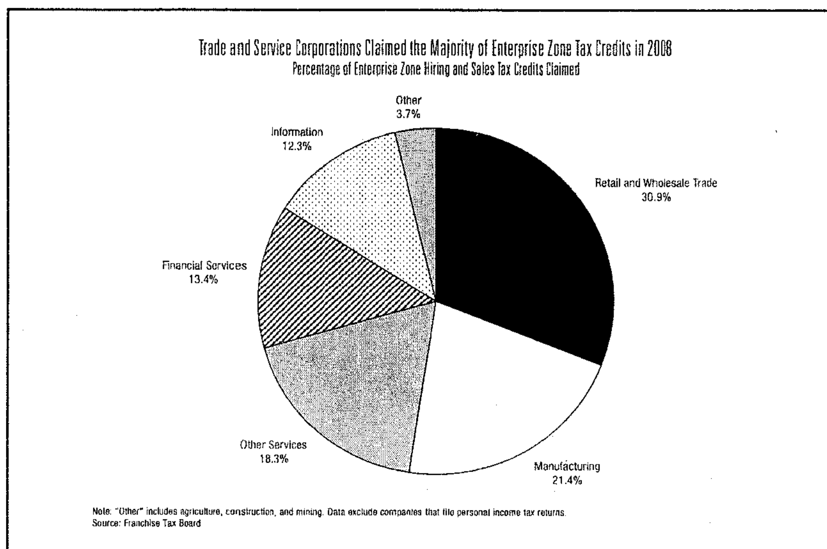
- **San Francisco corporations claim the largest share of EZ tax breaks.**

Approximately one out of eight dollars in corporate EZ tax credits (12.0 percent) were claimed by corporations in the San Francisco zone in 2008, at a total cost to the state of $25.5 million. In Los Angeles' five zones, corporations collectively claimed 20.0 percent of all EZ tax credits claimed by corporations, costing the state a total of $42.5 million. Corporations located in Long Beach, Fresno, Santa Ana, Antelope Valley, and San Jose also claimed substantial tax breaks, while those in rural areas with very high unemployment rates, such as Calexico, Delano, and Shafter, claimed relatively fewer tax breaks.



- **Trade and service corporations are heavy users of EZ credits.**

Retail and wholesale trade corporations claimed 30.9 percent of EZ credits in 2008, while other service corporations claimed 44.0 percent of credits – 13.4 percent for financial services, 12.3 percent for information, and 18.3 percent for other services. Manufacturing corporations claimed 21.4 percent of zone credits.



- **The best available independent research finds that California's EZ Program fails to create jobs.**

An extensive study by researchers at the Public Policy Institute of California found that "on average, enterprise zones have no effect on business creation or job growth."[5] Specifically, the study found that EZs "have no statistically significant effect on either employment levels or employment growth rates."[6] In addition, although the researchers do not directly assess the impact of EZs on unemployment or poverty, they argued that "it is difficult to see how these outcomes could improve in the absence of a positive effect on employment."[7] The researchers concluded that "the absence of evidence of a beneficial effect of California's enterprise zones on job and business creation clearly calls into question whether the state should continue to grant enterprise zone tax incentives."[8]

- **The LAO has recommended for years that the state eliminate or restructure the EZ Program.**

The LAO recently recommended that the Legislature approve the Governor's proposal to eliminate EZs, calling it one of several "sound, policy-based proposals" in the Governor's Proposed 2011-12 Budget.[9] In the past, the LAO has argued that "because they are expensive and not strongly effective, the area programs [EZs and other similar programs] should be eliminated or restructured."[10] The LAO concludes that "most research indicates that area programs [such as the EZ Program] have little if any impact on the creation of new employment and thus would not have a strong positive impact on the economic base of the state overall."[11]

- **The EZ hiring credit does not require the creation of new jobs.**

The high cost of the EZ Program is primarily attributable to the hiring tax credits, which cost the state $273.5 million in 2008 – 58.7 percent of the total cost of the EZ tax breaks.[12] Yet companies can claim hiring credits without creating new jobs, since the credits are for *new hires,* not *new jobs.* In other words, businesses could perpetually claim hiring credits for eligible workers who refill positions that open up due to normal turnover, without creating any new jobs over the lifetime of the EZ. In effect, 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.[13]

Companies can also claim hiring tax credits long after individuals begin work and even for workers who are no longer employed at a zone business, which the LAO has pointed out "provides more of a reward than an incentive."[14] 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. Given these flaws in

the program's design, it is not surprising that businesses indicate that EZ tax breaks are ineffective. Nearly half of businesses (47.1 percent) report that the EZ hiring credit "never" or "rarely" influenced their hiring decisions, and 61.5 percent report that it "never" or "rarely" played a role in deciding whether or not to retain workers.[15]

- **The majority of the hiring tax credits claimed are based on individuals' residency, not on barriers to employment.**

While EZ Program supporters claim that the program encourages employers to hire disadvantaged individuals, the overwhelming majority of approved credit vouchers – which companies must receive in order to claim the hiring credit – are for employees who merely happened to live at the right address. Nearly two-thirds (64.8 percent) of hiring credit vouchers approved by EZs in 2004 – the most recent year for which data are available – were for residents of Targeted Employment Areas (TEAs), regardless of their income or other characteristics.[16] Several other hiring credit eligibility categories also enable businesses to claim credits for workers regardless of whether they face barriers to employment.[17]

- **The EZ Program is too large to effectively direct business activity to areas most in need of assistance.**

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 workers is employed at a business located in one of the state's zones.[18] In fact, employment within at least seven EZs represents anywhere from one-quarter to more than half of total employment in the counties in which those EZs are located.[19]

- **EZ eligibility criteria are overly broad.**

The criteria for qualifying as an EZ have varied throughout the program's existence and have at times been changed to increase the likelihood that specific areas would be granted EZ status. Current state law includes criteria that do not adequately measure an area's overall economic well-being, such as "a history of gang-related activity, whether or not crimes of violence have been committed."[20] Moreover, state law does not require EZs to substantiate economic distress to retain their original 15-year designation, receive a five-year extension, or expand.[21] Consequently, many EZs have been in existence for up to 20 years. As the LAO has pointed out, "it is not clear what additional benefits will be gained by extending the same incentives that have already been in place for as many as 20 years."[22] In addition, this means that EZs can include neighborhoods that are not economically distressed. An analysis of Census tracts within the San Francisco EZ, for example, revealed that the majority of tracts failed to meet at least two economic distress criteria, as required for EZ eligibility.[23]

Alissa Anderson prepared this Policy Points *with assistance from Luke Reidenbach. 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. General operating support for the CBP is provided by foundation grants, subscriptions, and individual donations. Please visit the CBP's website at www.cbp.org.*

ENDNOTES

[1] These other programs include Targeted Tax Areas, Manufacturing Enhancement Areas, and Local Agency Military Base Recovery Areas.

[2] Legislative Analyst's Office, *California's Enterprise Zone Program* (March 10, 2010), p. 5.

[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.

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

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

[6] Jed Kolko and David Neumark, *Do California's Enterprise Zones Create Jobs?* (Public Policy Institute of California: June 2009), pp. 14-15.

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

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

[9] Legislative Analyst's Office, *The 2011-12 Budget: Overview of the Governor's Budget* (January 12, 2011), p. 15.

[10] Legislative Analyst's Office, *California's Enterprise Zone Program* (March 10, 2010), p. 5.

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

[12] The Franchise Tax Board (FTB) does not report lost revenues separately for the hiring credit and the sales tax credit, but FTB staff suggest that the sales tax credit costs the state significantly less than the hiring credit. Personal communication with the FTB (March 21, 2006).

[13] The maximum value of the hiring credit begins at 50 percent of 150 percent of the minimum wage and then declines for each additional year that a worker remains at a company. Companies can claim hiring credits for individual workers for up to a maximum of five years.

[14] Legislative Analyst's Office, *California's Enterprise Zone Program* (March 10, 2010). More than 4,200 tax returns were amended for tax years 1999 through 2003 that reduced companies' tax liabilities by claiming EZ tax credits, at a total cost to the state of $169.3 million – 14.5 percent of the cost of total EZ tax breaks claimed during that period. California Budget Project, *California's Enterprise Zones Miss the Mark* (April 2006).

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

[16] TEA residency allows employers to claim tax credits based solely on where a worker lives and not on any objective measure of whether the individual faces a barrier to employment. A TEA can include all or part of the zone itself, as well as additional areas that may or may not be adjacent to the zone. TEAs can only include census tracts in which more than half of residents have low incomes, defined as those who have incomes at or less than 80 percent of the area median. This definition allows a zone located in an area with high incomes to include census tracts that are not economically distressed in its TEA. For example, if a zone is located in an area with a median income of $100,000, the TEA could include census tracts where more than half of the residents had incomes of $80,000 or less. See California Budget Project, *California's Enterprise Zones Miss the Mark* (April 2006).

[17] For example, businesses can claim hiring credits for "ex-offenders" – a term that is not defined and that some EZ administrators have interpreted as individuals who have committed any type of infraction, including traffic violations. In addition, EZs have used an exception in the eligibility guidelines for the now-defunct Job Training Partnership Act (JTPA) Program to approve credit vouchers for individuals without documented economic disadvantage. The Workforce Investment Act, which replaced the JTPA Program in 2000, places a high priority on "universal access" and thus a lower priority on targeting services to disadvantaged persons. See California Budget Project, *California's Enterprise Zones Miss the Mark* (April 2006), pp. 10-12.

[18] Ted K. Bradshaw, *Cost-Benefit Analysis of California's Enterprise Zone Program,* prepared for the California Association of Enterprise Zones (June 5, 2003), p. 34. Using more recent data, researchers at the Public Policy Institute of California find that the number of workers employed at businesses in EZs for which complete data were available represented 10.9 percent of total employment in the counties in which those zones were located. The researchers estimate that those EZs represented 89 percent of total EZ employment in the state. See Jed Kolko and David Neumark, *Do California's Enterprise Zones Create Jobs?* (Public Policy Institute of California: June 2009), p. 7.

[19] In addition, in at least four EZs, the number of business establishments located in each EZ represented more than one-quarter to approximately 40 percent of the total number of establishments in the counties in which the EZs were located. Jed Kolko and David Neumark, *Do California's Enterprise Zones Create Jobs?* (Public Policy Institute of California: June 2009), pp. 7-8.

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

[21] Once designated, large EZs can expand their geographic boundaries by 15 percent, while smaller EZs – those measuring 13 square miles or less – can expand by 20 percent. To be granted five-year extensions, EZs must have received "a "superior or passing audit" and local jurisdictions comprising the zone must "submit an updated economic development plan ... justifying the need for an additional five years by defining goals and objectives that still need to be achieved and indicating what actions are to be taken to achieve these goals and objectives." Government Code, Section 7073(d).

[22] Legislative Analyst's Office, *The 2008-09 Budget: Perspectives and Issues* (February 20, 2008), p. 116.

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

ERASE ARTIFICIAL BARRIERS: FOCUS ON ENTREPRENEURSHIP

FEBRUARY 16, 2011

Eileen Norcross
Lead Researcher, State and Local Policy Program

California Senate Governance and Finance Committee

Chairwoman Wolk, Vice Chair Huff, and members of the Committee:

Thank you for inviting me to testify on policy alternatives to California's Enterprise Zone (EZ) program. Last year, I provided written testimony to the Committee on the effectiveness of the EZ program based on the extensive literature evaluating zone performance.

The EZ program has not had the impact on local economic development envisioned by those who designed the program. Where results have been achieved, they have been small relative to the cost borne by the state. However, the broad goals of the EZ— to encourage economic development and socially-beneficial entrepreneurship—can be met without direct intervention or a loss of revenue.

In fact, there is much work ahead for California policy makers to accomplish the goals articulated by EZ policy. The toolkit available to policy makers is limited but powerful. It includes California's tax structure, fiscal regime, and regulatory environment. In the coming months and years, these must be reformed through the application of general principles of neutrality, stability, sustainability, and transparency. By establishing predictable and stable rules based on pro-growth policies, California will signal to residents and investors that the state is a place where individuals, businesses, and communities can thrive.

I will touch on each of these areas an offer more specific suggestions. I will conclude my testimony with some general thoughts on economic development.

TAXATION

California's tax system is in need of reform. Consistently ranked as a state with the nation's highest income, corporate, and sales taxes, California's taxpayers face the highest marginal tax rate on income, with a top bracket of 10.55 percent on those earning over $1,000,000. Many small businesses are taxed under the individual code (partnerships, sole proprietorships, and LLCs). Effectively, this high rate makes it difficult for small businesses to expand, hire, and create jobs.

California's sales tax at 8.25 percent is riddled with exemptions resulting in a tax that is inefficient and distortionary. As the Tax Foundation notes, while California's sales tax has a high rate, its collections are relatively low.[1] In FY 2007 California's collections lagged behind 12 other states. The sales tax's narrow base applies to just 34.7 percent of goods and services, compared to a national median of 43.6 percent.[2] The Tax Foundation further estimates that if California were to broaden the base of the sales tax to include all goods and services, while still exempting business-to-business transactions, the rate could drop between 7.25 percent and 5.8 percent without a loss in revenue.[3]

The elimination of the EZ is a step towards greater neutrality in California's tax code. However, it must be recognized that the credits are considered valuable by those businesses currently claiming them, in part because of California's high rates of taxation on small business owners through the personal income tax and the high rate of taxation on corporations.

To encourage economic development of all types—small businesses, individual entrepreneurship, and corporate expansion

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[1] Joseph Henchman, "A Golden Opportunity: California's Budget Crisis Offers a Chance to Fix a Broken Tax System" *Fiscal Fact* no. 170, May 18 2009, http://www.taxfoundation.org/research/show/24712.html.
[2] John L. Mikesell, "State Retail Sales Tax Burdens, Reliance and Breadth in Fiscal 2003," *State Tax Notes* 125 (July 2004).
[3] Henchman, "A Golden Opportunity."

and job creation—California lawmakers should continue to apply these principles to the state's tax system: broaden the base, lower the rate, and strive for greater neutrality by eliminating exemptions and incentives. This will transform California's tax system into one that is less complex, more transparent to taxpayers and businesses, non-discriminatory, and one that is pro-growth. It will also have the benefit of reducing volatility in revenue collections and increasing fiscal stability for the state.

LASTING SPENDING REFORM

California's spending has outpaced growth in inflation and population over a two-decade period. Since 1991, spending grew at an average of 5.91 percent annually, while population plus inflation grew by 4.38 percent annually.[4] This has driven the size of the state's continuing budget gaps. In addition to ongoing yearly gaps, California must contend with the significant promises it has made to public sector workers in the form of pensions and benefits. Undertaking reform to the pension system is necessary to stabilize the state's fiscal future and to ensure commitments are met. That means reform must begin now and include ending the defined benefit plan and switching new hires to a defined contribution plan. This policy move will also send a powerful signal that California is pursuing structural fiscal reforms in order to reduce its long-term debt, and the risk that this presents to taxpayers, and to meet its commitments to workers who have earned rights to their benefits.

DECENTRALIZATION

The passage of Proposition 13 in California in 1978 achieved a short-term policy goal of keeping taxes low on the local level. But as economic theory would predict, the long-term outcome of Proposition 13 was to leave localities more dependent on state revenues to support local services. Without the ability to raise taxes to support schools and other local services, localities in California have turned to other sources to fund spending, including increased local sales taxes; the "fiscalization of land-use policy" and "sales-tax farming" to attract businesses with high sales-tax receipts, eroding family-owned businesses; an increased reliance on government fees; the rise in special assessment districts; and also the underfunding of city pensions. All of these are outcome that result from local governments attempting to circumvent the limits imposed by Proposition 13.[5] In addition, Proposition 13 increased local reliance on state revenues, contributing to the state's current fiscal problems. Transfers from a higher level of government to a subsidiary level may induce greater spending on the local level by softening the hard budget constraint facing local government. In other words, localities spend beyond what they can support in own-source revenue, contributing to poor fiscal discipline on the local level.

Currently, Governor Brown is considering how to undo the centralization that occurred as a result of Prop 13. This is an important reform that if properly implemented will help put the state on more stable fiscal footing. Activities that can be performed on the local level should be left to localities. This approach has several benefits. First, fiscal decentralization ties revenues more directly to the activities being funded, contributing to transparency and making it easier for local residents to evaluate the effectiveness of spending. This in turn promotes greater community involvement on the local level and thus greater policy flexibility and variety for both local government, as well as greater fiscal stability for the state government.

REGULATORY ENVIRONMENT

Currently, a bipartisan effort is underway to introduce regulatory reform to the state of California. The effort to establish a process to review and analyze regulations' economic impact and effectiveness is an essential step towards weighing the costs and benefits of regulations on the state's economy. In a 2010 report, the Institute for Policy Integrity states that "California's Office of Administrative Law—praised as one of the nation's first, most active, and independent review entities—runs a review process that frustrates many agencies."[6] In practice, economic analysis is not employed in the preparation of impact statements with cost estimates, which are "prepared by first making a preliminary, 'not particularly scientific' estimate and then relying on regulated industries to critique and refine the estimate during the public comment period."[7] While improving the assessment of regulations may be difficult given the current fiscal pressure in the state, a gradual process of implementing a more rigorous review of regulations will have long-term benefits for the state's improving the quality of regulation.[8]

Encouraging economic development and socially beneficial entrepreneurship requires policies that tackle the structural

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[4] Adam B. Summers, "California's Spending by the Numbers: A Historic Looks at State Spending from Governor Pete Wilson to Governor Arnold Schwarzenegger," Reason Foundation, February 2009, http://reason.org/files/a2ec7caccc5d660e870c4a21526ef5f8.pdf.

[5] Colin H. McCubbins and Mathew D. McCubbins, "Proposition 13 and the California Shell Game" (Center in Law, Economics and Organization, Research Paper Series and Legal Studies Research Paper Series, University of Southern California Law School, 2009).

[6] Jason A. Schwartz, *52 Experiments with Regulatory Review: The Political and Economic Inputs into State Rulemaking* (New York, NY: NYU Institute for Policy Integrity, November 16, 2010).

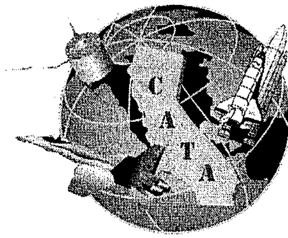
[7] Ibid, 171.

[8] See also, Robert N. Stavins and Todd Schatzki, "Comments on the Little Hoover Commission's Study of Regulatory Review in California," http://www.lhc.ca.gov/studies/activestudies/regulatoryreform/Stavins.Schatzki%20testimony.pdf.

weaknesses in California's tax system, fiscal institutions, and regulatory environment. California is moving in the right direction on all of these fronts. Applying the principles of broad-base, lower-rate taxation will lead to a more pro-growth economic climate for investors, entrepreneurs, and individuals. Addressing the structural problems with California's budget will require a commitment to pension reform, arguably one of the most pressing factors to affect California's long-term fiscal prospects. Addressing the fiscal imbalances created by Proposition 13 through the promotion of greater decentralization is an important step towards improving the state's finances, as well as granting more autonomy to local units of government. Lastly, California can send a powerful signal by committing to improvement of its regulatory review process.

The rules of the game matter deeply. Ultimately, it is this framework that determines the amount and kinds of entrepreneurship that occur in society. The goal of public policy should be to promote variety and innovation by setting rules that are neutral, clear, reduce uncertainty, are easy to administer and evaluate, and are predictable for residents and the state. These rules should be based on the principles discussed above. Economic development is ultimately a local phenomenon that depends on the institutional setting and is based on promoting the greatest amount of flexibility to allow individuals to take risks, to innovate, and to flourish.

By instituting such reforms, the state can achieve the goals that it is trying to reach today: greater fiscal stability, improved quality of life, and economic prosperity.



California Aerospace Technology Association

OPPOSE ELIMINATION OF ENTERPRISE ZONES AND PROTECT JOBS AND INVESTMENT IN CALIFORNIA

California's Enterprise Zones continue to boost our economy and are essential tools in California's economic recovery. We strongly urge the Legislature to **reject the proposal to eliminate the state tax credits** that form the critical backbone of the EZ incentive package. EZs are one of the few economic development tools that enable cities and counties to bring jobs to depressed areas. This proposal will hurt our underserved and distressed communities.

These valuable tax incentives improve economically distressed communities and spur job growth. Businesses cannot claim any of the EZ tax benefits unless they engage in job creation or equipment investments. If a business does not engage in the desired activity, then it cannot claim any of the tax benefits. A recent study by Applied Development Economics found that, for every dollar in tax incentives provided by the state, $1.35 was gained in tax revenues. Other studies have shown measurable benefits by reducing unemployment, lowering poverty rates, and encouraging business growth opportunities. An HCD-commissioned report found decreases in poverty levels and unemployment rates in zones, as well as increases in income levels.

Eliminating Enterprise Zone credits will greatly reduce California's ability to attract new and retain existing businesses, and the proposal will further weaken our job market and the state's economy. The EZ program is an important economic development incentive that is a collaborative state and local partnership intended to spur economic investment from the private sector. While some argue that EZs simply shift jobs from one part of the state to another, in fact the EZ Program has ensured that many jobs are retained in California. This has been particularly true with California's aerospace industry, such as in the Palmdale, Long Beach, San Diego, and San Jose Enterprise Zones.

Our state's unemployment rate is above 12% and this program helps create and retain jobs in areas where investment is needed the most. Such a radical proposal to eliminate it makes little sense with our state's high rate of unemployment. Sacrificing this important program will not help our state retain or create jobs and investment. Instead, it will only continue our current economic struggles. Now is not the time to abandon the State's commitment to these struggling communities.

Reform of the program is appropriate to address some of the concerns raised by opponents, but elimination is not a responsible approach. We engaged last year in numerous discussions about changes to the EZ Program. Unfortunately, those negotiations were abandoned by other groups. We urge you to reject the proposal to eliminate EZ tax credits.

Business Community's Suggestions for Improving the EZ Program's Incentives
Submitted to the Senate Revenue & Taxation Committee
March 2010

Apply the apportionment formula in the net operating loss (NOL) deduction to any zone-derived income. The formula discriminates between similarly situated taxpayers and has no impact at all on those located solely within a single EZ. However, taxpayers that operate in and out of EZs, as well as in multiple EZs, should not be treated differently. This formula unfairly limits the use of EZ tax incentives.

Apply the apportionment formula in the hiring and sales tax credits to any zone-derived income. The same applies with the EZ tax credits. At a minimum, these credits should be allowed to be used to offset income and tax liability in other EZs, as was proposed in AB 2589 (Runner).

Expand the net interest deduction (NID) to eliminate the "located solely within an EZ" language so that lenders can provide funds to multi-zone employers and employers that operate in and out of EZs. Current law limits the businesses to only those located solely within an EZ to qualify a lender for the NID. This is a significant impediment to lenders and businesses seeking qualified loans.

Increase the amount of the one-time employee tax credit of $525 to $1,000 per employee. The amount of this credit has not been changed since the credit was first enacted. This is the only direct benefit to an EZ employee. All other EZ benefits accrue to the employer.

Create a tax credit for real property and building purchases. The EZ tax benefits are those for hiring certain disadvantaged individuals and for the purchase of specified equipment. It is important in the EZ applications and for expanding and attracting businesses to an EZ to have available real estate and building space. However, the State does not provide any tax incentives for such purchases. There should be a credit for those types of purchases as well.

Change the sales/use tax credit to a sales/use tax exemption for equipment used in EZs. The equipment includes manufacturing, assembly, pollution-control, and energy conservation equipment. This change would help start-up businesses in particular by no longer forcing them to overpay for much needed equipment and then waiting over a year for the income tax credit to be available.

Equalize the amount of the cap on qualifying equipment purchases for the sales tax credit to $20 million regardless of the taxpayer's entity. Under current law, entities taxed under the personal income tax law can only qualify the first $1 million in purchases, while corporations can qualify the first $20 million in equipment purchases. This favors one type of entity structure over others.

California's Enterprise Zone Program:
What They Mean for California Businesses

- A "**Cost-Benefit Analysis of California's Enterprise Zone Program**" conducted by Applied Development Economics, an independent economic research firm (August 2006), has shown that Enterprise Zones are achieving their intended purpose by helping the most distressed areas of the state to stop decay and stimulate growth...significant growth.

- A 2006 report to the Department of Housing and Community Development found:
    - Poverty decreased 7.35% more in zones than in the rest of California.
    - Unemployment rates fell by 1.2% more than the rest of the state.
    - Household incomes grew 7.1% faster in zones.
    - The wages and salary levels in zones grew 3.5% more than the rest of the state.

- Enterprise Zones net benefit is 1.35 times the cost— a 35% return on the state's investment..

- New jobs associated with Enterprise Zone hiring credits may be in excess of 56,000 for 2004. (HCD Report, August 2006)

- Job creation in Enterprise Zones show an average starting salary 33% above minimum wage.

- Dr. Bradshaw from UC Davis found that the EZ program has played a key part in statewide job expansion, has created jobs for those with barriers to employment and has been highly successful in turning distressed areas into places with businesses, jobs and higher wages.

- Contrary to the PPIC study, researchers at USC found that when looking at a number of outcomes including employment, unemployment rates, poverty rates, and fraction of households with wage and salary income, **California's EZ Program decreases unemployment and poverty rates and increases incomes.**

- Enterprise Zones create jobs and positive social benefits that add to the economic benefits for the state. Many of these employees were previously drawing some form of public assistance. Over $40 million in cost savings to public assistance can be assumed in 2002 alone...plus these individuals are now earning income!

California's Enterprise Zone Program: Keeping Businesses Here and Employing Disadvantaged Residents

In this economic downturn, we need to do all that we can to create jobs and keep people employed, and Enterprise Zones do exactly that. They especially help hard-to-hire individuals find work in the places that they live. The Enterprise Zone Program is one of the state's most successful economic development tools – combating poverty and unemployment in disadvantaged areas of our state and encouraging business growth and expansion.

Stimulating Growth in Targeted Areas

- California's Enterprise Zone Program was established in 1986 in order to stimulate business investment in depressed areas of the state and create job opportunities for residents.
- There are 42 zones throughout the state each providing local incentives and special assistance to businesses located within the zone boundaries.

Promoting Employment for Disadvantaged Workers

- The Enterprise Zone program gives employers an incentive to hire people who are motivated to find jobs but face certain barriers to employment.
- Job creation in Enterprise Zones show an average starting salary 33% above minimum wage.
- Small businesses with 50 or fewer employees constitute 75% of the companies utilizing the Enterprise Zone Hiring program

Stabilizing Communities

- Enterprise Zones contribute to added local benefits such as overall economic vibrancy from business and job growth, added sales and property tax, building permit fees, land use improvements, and reduced blight.

Benefiting the State

- Zones account for nearly 300,000 jobs generated over a ten-year period, and that growth brought funds to the state treasury through income tax, sales tax and corporate tax.
- Enterprise Zones result in reduced state spending on social services by creating jobs for economically-disadvantaged people who in turn are often no longer dependent on the state to provide welfare, food stamps and unemployment benefits.

MAKING REFORMS TO CALIFORNIA'S ENTERPRISE ZONE PROGRAM

Submitted by Chris Micheli
To the Senate Governance & Finance Committee
February 9, 2011

Both proponents and opponents of California's Enterprise Zone Program engaged in months of constructive dialogue during 2010 in an effort to make a series of reforms to the EZ statutes. These discussions began after the Assembly Jobs, Economic Development and the Economy Committee concluded its three informational hearings around California (in Sacramento, San Jose, and San Diego) and received over 110 recommendations for reform. Similarly, the former Senate Revenue & Taxation Committee, as well as its Assembly counterpart, held several informational hearings in 2009 and 2010 examining the EZ Program and the need for changes to the EZ statutes. While a consensus work product was not achieved in 2010, reform of the program, rather than the Governor's proposed retroactive repeal of the EZ tax credits, is still warranted.

Although interested parties would have to return to the "negotiating table" to continue their work to develop a comprehensive package of reforms to both the Government Code and Revenue & Taxation Code provisions affecting the Enterprise Zone Program and the state's incentives, there is broad support for making substantive changes to the EZ statutes. The purpose of these changes is to enhance the Program's effectiveness, which has been the core interest of the Legislature. The following reforms could be readily adopted:

* Enhanced reporting by adding new requirements to track and annually report local and state resources dedicated to EZ activities

* Additional hiring and sales tax credit reporting requirements with detailed data

* De-designation of "poor performing" EZs

* Limiting the geographic size of EZs

* Refinements to targeted employment areas, including a salary cap and narrower geographic boundaries

* Improving the linkage between EZs and workforce and community development activities

* Increasing the use of CalWORKS clients and unemployed individuals

CALIFORNIA'S ENTERPRISE ZONES:

Creating Jobs. Building Communities. Investing in California's Future!

An Investment in Jobs

California continues to grapple with double-digit unemployment levels. Areas in which enterprise zones are located have significantly higher unemployment rates, some reaching close to 40 percent for minority populations.

At a time when many businesses cannot afford to hire new employees, enterprise zones helped create 20,000 new jobs in the past year alone.

At a time when many businesses are laying off employees, enterprise zones benefits assisted more than 92,000 employees keep their jobs.

In 2010, enterprise zones create or retain 10,000 jobs across the state every month.

An Investment in Fiscal Solvency

Administration of the enterprise zones program is not funded out of the state's general fund. All program funding comes from voucher fees, which netted $1 million last year alone to run the program.

Over 18,000 employees in enterprise zones are previous recipients of some type of public assistance (CalWORKS, MediCal, unemployment, food stamps, etc.). If enterprise zones are eliminated, many businesses will downsize and employees will be forced back on government assistance, increasing the burden to California taxpayers.

An Investment in Our Communities

Enterprise zones encourage businesses to locate, or in some cases expand, to economically distressed areas and hire local employees. These employees in turn spend more in their local community. They spend money in local stores and at local restaurants. The far-reaching benefits of enterprise zones help revitalize every aspect of a community.

Enterprise zones provide incentives for employers who hire former felons. Several studies have demonstrated that gainful employment significantly reduces the probability that an offender will re-offend. By investing in enterprise zones, we are investing in the safety and security of our communities.

In 2010, Enterprise Zones created 20,462 new jobs in California at a time when the state is experiencing unprecedented unemployment.

CALIFORNIANS FOR
Jobs and Safe Communities
SPONSORED BY CALIFORNIA ASSOCIATION OF ENTERPRISE ZONES IN ACTION

for more information visit www.jobsandsafecommunities.com

CALIFORNIA'S ENTERPRISE ZONES:

Creating Jobs, Building Communities, Investing in California's Future!

In 2010, Enterprise Zones created or retained more than 118,000 jobs in California.

By the Numbers

There are 42 enterprise zones throughout California. Located in economically distressed areas, these zones typically have record-high unemployment, higher crime rates and lower levels of economic activity. Enterprise zones provide incentives for businesses to open and/or relocate to these areas, hire local employees and help revitalize the local economy.

10,000: Jobs created or retained each month in California thanks to the Enterprise Zone Program.

18,317: Employees previously on public assistance now employed by businesses taking advantage of enterprise zone tax credits.

2,415: Ex-offenders employed by businesses utilizing enterprise zone tax credits. Gainful employment is one of the largest contributing factors affecting recidivism. (*The average cost of incarceration in a California state prison is approximately $50,000* per inmate per year . By giving these ex-offenders a job, enterprise zones saved the state over **$120 million** in 2010.*)

2,337: People employed by businesses who were previously receiving unemployment benefits. The average weekly unemployment payment in California is $293**. (*By giving these employees a job, enterprise zones saved California's burgeoning unemployment insurance fund $32.9 million in 2010.*)

416: Veterans hired by businesses utilizing enterprise zones.

42: Number of enterprise zones in California encouraging business and job growth while helping aid the state's economic recovery.

Keep Jobs in California
Keep Businesses in California.
Keep Enterprise Zones in California.

*http://www.kpbs.org/news/2010/jan/08/overcrowded-and-expensive-governor-addresses-calif
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Enterprise zones provide significant savings to our state budget by stimulating the economy and putting people back to work.

Testimony submitted by: Nancy Vellis, Housing Technician
Eureka Redevelopment Agency

Thank you for the opportunity to speak today about the importance of the Enterprise Zone Program to our small community. The impact of this program is best told by two local business start-ups.

LOST COAST BREWERY

Founded in 1986 by Barbara Groom, the Lost Coast Brewery is one of the only female-owned and operated breweries in the United States. The Lost Coast Brewery is located in Eureka, California in the heart of the Redwood country and is famous for its delicious and award-winning beers.

Ms. Groom says she has been able to grow the Lost Coast Brewery in part because of the Enterprise Zone credits the business receives. "We have been able to reinvest the money we have saved and grow our business and hire more employees faster than other brewers in the area," says Ms. Groom. Operating a 40,000 barrel brewery (compared to 12,000 barrel breweries in the area), Ms. Groom says "The tax savings we receive also allows us to pay our 77 employees higher wages than our competitors."

The Lost Coast Brewery distributes its beers nationwide and Ms. Groom is looking at building another new brewery. "We want to stay in Eureka because of the Enterprise Zone credits we receive," she says. "That is what is holding us here -- otherwise we would be looking elsewhere."

EUREKA NATURAL FOODS

Eureka Natural Food Stores started over 20 years ago with four people. Today, the successful, independent, family-owned business has 75 employees and offers full benefits which include vacation, healthcare, vision, dental, and a retirement package.

"When we first started we had a tiny store," said owner Rick Littlefield. "Since then we have moved four times, expanded our operations and hired more employees. We have been to do all of this because of the Enterprise Zone Program."

"You have to prime the pump," continued Littlefield. "You have put in the effort before it begins to pay off. This is what the Enterprise Zone Program does; it helps small businesses get going. It has helped us grow our company, hire more employees and pay them a living wage ($10 or more per hour plus benefits)."

"The region which was once dependent on the timber industry is now becoming now more diversified," says Mr. Littlefield. "Natural foods are an important part of Humboldt County's future and the Enterprise Zone Program is helping companies like mine create good-paying jobs. Eureka Natural Food Stores, which supports organic farming and sustainable agriculture, is continuing to grow in popularity, bringing benefits to employees, customers, suppliers and the greater community."

These are just two examples of businesses that are able to flourish because of the benefits earned in through the Enterprise Zone Program.

The program is working, in 2010 alone, there were 364 businesses utilizing EZ benefits. 114 new jobs created, 566 jobs retained and 81 employees off public assistance. Please do not eliminate this valuable program. Our community needs it.

February 22, 2011

The Honorable Lois Wolk
California State Senate
State Capitol, Room 5114
Sacramento, CA 95814

Re: CalTax's Concerns with Mandatory Single Sales Factor

Dear Senator Wolk:

Thank you for allowing CalTax to provide written testimony to the Senate Governance and Finance Committee regarding the proposal to move from an elective to a mandatory single sales factor approach for apportioning corporate income to California.

When the Legislature established the elective single sales factor in 2009, it recognized that there is merit in both the single sales factor and the three/four-factor apportionment (property, payroll and sales (or double-weighted sales) formulas.

As you know, the elective single sales factor was negotiated as part of a stimulus package to help offset the $12 billion tax increase on California employers to help close the budget deficit of 2009. Employers willingly supported the tough choices the Legislature had to make in increasing taxes , in light of the balanced tax policy that recognized that California values businesses that invest in the state as well as those that have a significant employer base in the state. Undermining these incentives would undermine employers' faith in that commitment, taint the mood of current budget negotiations, and hinder the state's economic recovery by picking winners and losers depending on different types of business models.

California taxes a percentage of the business income of a multistate business, as determined by an apportionment formula. The formula does not determine the actual dollar amount of income earned in this state, but determines a rough approximation. For some businesses, the three/four-factor formula results in higher taxes for businesses that decide to increase payroll and property in California, thus encouraging businesses to leave California. For these taxpayers, it makes sense to

use a single sales factor to avoid the harsh penalty for increasing payroll and property in California, thus improving the California business climate.

However, this does not mean that the three/four-factor apportionment formula that is allowed by statute fails to fairly apportion income to California for some corporations. In fact, the Franchise Tax Board will say, and has said for many years, it fairly apportions income. If this was not the case then the three/four factor apportionment formula has been illegal for almost two decades. It has been argued for many years that this formula fairly apportions business income to this state. It can result in multistate taxpayers paying the right amount of tax. Therefore, why should taxpayers be denied its use, as the governor proposes?

In light of income already being fairly apportioned to this state, the only result of the current proposal to make single sales factor mandatory for most multistate taxpayers will force many corporations to pay more taxes than they owe to California. To hit a subset of the business community with a corporate tax increase of $1.41 billion through a change in the apportionment formula would clearly allocate more money to California than is actually earned in the state.

California's tax structure – indeed, any honest tax structure – must be built upon the principle that taxpayers should pay no more and no less than they owe. Requiring most taxpayers to use a single sales factor, even when the prior formula results in a more accurate approximation of California-sourced income, would violate this principle.

Additionally, a mandatory single sales factor would impose a significant tax increase on many California employers, discouraging them from investing in the state's recovery. On the other hand, allowing businesses to choose the best formula to operate, employ and sell in the state provides an economic incentive to invest here, despite many other disincentives that currently exist in California. Given that an economic recovery will be the best source of new revenue for state and local governments, this is a significant policy consideration.

Critics of the elective single sales factor erroneously state that multinational and out-of state companies receive an unfair tax advantage by tapping California's large market without heavily investing in jobs and infrastructure in the state. This mischaracterization fails to recognize that certain business models do not easily fit in a single sales calculation. Many out-of-state companies have significant investments of property and payroll in California, but the size of their sales in one of the largest markets in the world render those investments moot by comparison.

Critics also opine that multistate taxpayers should not be able to choose how they apportion their income to California, and further state that relying on one method of filing achieves the goal of certainty. However, certainty is just one factor among many in establishing sound tax policy. California's tax policy also must be equitable and fair. Existing tax policy at both the federal and state level includes many choices for how taxpayers prepare their tax returns. In fact, at last count, there were more than 100 different elections, ranging from depreciation methods,

inventory valuation treatment, IRA treatment, and disaster loss treatment to name a few.

Requiring the new apportionment methodology to be mandatory is nothing short of a massive tax increase on an existing group of taxpayers already contributing to the California economy through one of the highest corporate tax rates in the country. Shifting the tax burden to these companies unfairly targets companies that choose to do business in the state, regardless of where they make their headquarters, and further erodes California's ability to attract and compete for business. The state should not be in the business of picking winners and losers among industry segments, but should encourage economic growth and California jobs.

For these reasons, CalTax must respectfully oppose moving from an elective to a mandatory single sales factor. Please call me at 916-930-3105 or e-mail at suzanne@caltax.org with any questions.

Sincerely,

Suzanne Sutton
Legislative Advocate

cc. Senate G&F members

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