Round II Directors' Summit

May 3, 2005

Connie Mack, III
Chairman
The President's Advisory Panel
on Federal Tax Reform
1440 New York Avenue, NW, Suite 2100
Washington, DC 20220

Dear Chairman Mack:

The following is submitted on behalf of the undersigned Summit of Directors of U.S. Department of Housing and Urban Development-designated Round II Urban Empowerment Zones ("the Summit of Empowerment Zone Directors").

The Summit of Empowerment Zone Directors is comprised of the executives of local community redevelopment strategies across the country, who have had direct experience implementing tax incentive marketing efforts for community redevelopment purposes.

Description of the Proposal

Background
Section 952 of the Taxpayer Relief Act of 1997 amended 26 U.S.C. 1391 and 1392 to authorize the U.S. Department of Housing and Urban Development ("HUD") to designate 15 Urban Empowerment Zones (known generally as Round II EZs). Pursuant to that authority, HUD created regulations at 24 CFR 598. Those regulations created a process by which communities that met federal statutory criteria of "pervasive poverty and social distress" could nominate areas to be designed by HUD as Round II Urban Empowerment Zones. The regulations also governed the implementation and conduct of so-designated Round II EZs.

Under the application process, communities proposed local revitalization strategies that were based on the presumed availability of $100 million in federal grant funds and the marketing of certain newly-available federal tax incentives for businesses.[1] Thirty-five percent (35%) of the competitive evaluation was based on each community's plan for marketing the tax incentives to businesses. One hundred nineteen (119) communities applied, and through the

[1] The federal tax incentives for Round II EZs include: Increased Section 179 Deduction (accelerated depreciation on the purchase of equipment and machinery), Enterprise Zone Facility Bonds (tax exempt bonds for qualified zone property), Qualified Zone Academy Bonds to fund building of specialized schools, extension of the Work Opportunity Tax Credit to cover EZ youth, EZ Employment Credit to cover EZ businesses hiring EZ residents, and Partial Exclusion of Gains on the Sales of Certain EZ Stocks

competitive selection process, the 15 designations[2] authorized by the U.S. Congress were made effective January 1, 1999.

Experience of the Round II EZs in Marketing Tax Incentives

Each of the Round II EZs has since implemented their locally-derived strategies, designed primarily to increase investment, job creation, and employment of zone residents. Each of these strategies has employed a combination of direct investment of highly-leveraged federal grant funds and marketing of the federal tax incentives.

Through this five years of experience, the Round II EZ Directors have come to a unanimous conclusion:

> *The flexible federal grant funds have been critical to the success of each community's redevelopment efforts, but the federal tax incentives have not appeared to be particularly valuable in those efforts.*

This conclusion, from nearly six years of direct oversight of the tax incentives marketing effort, is a critical observation that should inform policy-makers on effective federal community revitalization strategies. It comes from the independent experiences of development professionals from across the country, in large and small urban communities.

Issues Noted by Round II EZ Directors

The Round II EZ tax incentives are designed to encourage businesses to hire residents from the Empowerment Zone and to encourage investment in capital assets of Empowerment Zone businesses. Experience has shown that the various credits are of marginal use to most businesses.

Through thousands of meetings with business executives and human resources personnel, the Empowerment Zone Directors have heard that the credits are generally so small that they cannot by themselves induce a desired investment. However, in concert with direct investment from the zones, the incentives can be helpful. In some instances, businesses cite the record-keeping complexities as being a barrier toward utilization of incentives. In other instances the human resources and tax functions are so widely segregated (by function and/or by geography) that the hiring staff has absolutely no concern about the potential tax benefits of hiring zone residents. In other instances, there is simply complete disinterest on behalf of the business owner.

The EZ Employment Credit is one incentive marketed by Round II EZs. Unfortunately, they are hard to use by the closely held businesses and family-owned businesses most likely to populate our distressed communities. Thus, the same businesses most likely to generate employment and high growth rates are generally not eligible for the credit at the time in their

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[2] The Round II EZs include: Santa Ana, CA; New Haven, CT; Miami-Dade, FL; Gary/Hammond/East Chicago, IN; Boston, MA; Minneapolis, MN; St. Louis, MO/East St. Louis, IL; Cumberland County, NJ; Cincinnati, OH; Columbus, OH; Columbia/Sumter, SC; Knoxville, TN; El Paso, TX; Norfolk/Portsmouth, VA; and Huntington, WV/Ironton, OH.

growth cycles when it would be must helpful. Nationally, corporations and individuals claimed an estimated total of $251 million in EZ Employment Credits between 1995 and 2001. In 2001, 559 corporate returns claimed a total of $23.4 million in EZ Employment Credits.[3]

In general, EZ Directors suspect that most businesses using the EZ Employment Credit do little more than hire specialized tax credit claiming businesses to scan their payroll rosters for employee addresses in the EZ at tax filing time, in order to determine the amount of credits they can claim. EZ Directors are doubtful that significant numbers of EZ resident hirings are motivated by the presence of the incentive.

The overall failing of tax incentives as a strategy to achieve community redevelopment is in the fact that a causal relationship between credits claimed and new investments or new hires can never be established. While there will always be a correlation between, for instance, accelerated depreciation and investment in a zone asset, there can never be any certainty that the presence of the ability to depreciate *caused* the new investment. In reality, the federal government is as likely as not simply subsidizing existing and already planned business activity.

This is despite the huge federal tax revenue being lost to the tax incentives ("tax expenditures"). The Budget of the United States projects the five-year (2006-2010) federal tax expenditure on the EZ, EC, and RC programs at $6.9 Billion.[4] In an era of increased accountability for results and high federal budgetary pressures, it seems to be a step backward to have huge federal tax expenditures without any sense of whether they are *causal* in creating the conditions for revitalization.

Enterprise Zone Facility Bonds are another incentive marketed by Round II EZs. This is potentially a very valuable tool; however, several statutory provisions reduce the number of projects that can be financed effectively with EZ facility bonds. Specific concerns cited by businesses include the costs of issuance precludes smaller projects from this financing (a nonstatutory issue), the 35% EZ resident employee requirement for the life of the bonds, and the lack of clarity regarding the "active conduct of business" regulation that requires a "substantial portion" of the businesses' work to occur in the zone. Many businesses are simply unwilling to take the risk of having to remain in compliance over what could be a 30-40 year timeline.

<u>Issues Raised by Round III EZ and Renewal Community Directors</u>

In addition to the concerns raised by Round II EZ Directors, we would also note that a coalition of Round III EZs and Renewal Communities (both designations are tax incentives-only designations) is now seeking to liberalize the regulations surrounding some of those tax incentives, in order to make them potentially more useful.

[3] U. S. General Accounting Office, *Community Development: Federal Revitalization Programs Are Being Implemented, but Data on the Use of Tax Benefits Are Limited, GAO-04-306* (Washington, DC: March 2004), Page 31.
[4] Office of Budget and Management: *Analytical Perspectives: The Budget of the United States Government, Fiscal Year 2006*, "Table 19-1. Estimates of Total Income Tax Expenditures," Page 318.

In a February 15, 2005 letter to HUD Secretary Alphonso Jackson, Karl Hillerman, Chairman of the Oklahoma City Enterprise Community and Empowerment Zone Governance Committee, writes the following on behalf of 13 designated areas:[5]

> "To insure that the goals and objectives of the EZ/RC legislation are realized, it is important that certain changes be made. By way of example, current statutory language, in large part, negates the use of bonds in the EZ's and leaves unworkable the Commercial Revitalization Deduction in the RC's."

Mr. Hillerman then goes on to cite, "based upon our direct experience with the programs," nine priority changes that would need to be made to the tax incentives to make the Round III EZ and Renewal Community programs more effective. This measure of dissatisfaction with the tax incentives coming from the newly-designated areas who had applied for the tax incentives-only designation, illustrates again the frustrations in implementing tax incentive programs that have turned out to have had marginal community revitalization impact, at best.

Finally, none of the EZ or RC programs are able to measure the effectiveness of their local tax incentives marketing efforts. Use of credits is claimed on private tax returns to the Internal Revenue Service. The local Empowerment Zones do not have access to this information, and most businesses will not typically share their tax return with the zones.

Issues Noted by Other Evaluators

A recent report of the General Accounting Office concurs with the direct experience of the Round II EZ Directors. The GAO found that the IRS does not collect much data on the use of the tax benefits available to businesses in designated communities:

> *"The lack of data on the use of the tax benefits available to businesses in the designated communities limits the ability of (1) HUD and USDA to administer the programs; (2) designated communities to attract additional resources; and (3) HUD, USDA and others to audit or evaluate the programs."*[6]

HUD does not have access to this information, and the IRS is prohibited by both law and by resources from gathering relevant information and sharing it with HUD. The IRS collects national level data on just two of the five EZ tax benefits, and the General Accounting Office ("GAO"), in a review of the tax incentives program, confirmed that the IRS cannot reliably link any of that data to a designated community.[7] In short, the program with its huge tax costs ($6.9 billion over five years) is unmanaged, unmeasurable, and unaccountable for results.

[5] These areas include HUD-designated Round III Empowerment Zones ("Round III EZs") and Renewal Communities ("RC"), both tax incentives-only community revitalization programs that received their respective designations under the Community Renewal Tax Relief Act of 2000.

[6] U.S. General Accounting Office, *Community Development: Federal Revitalization Programs Are Being Implemented, but Data on the Use of Tax Benefits Are Limited, GAO/RCED-04-306* (Washington, DC: March 2004), Page 6.

[7] Ibid, page 35.

In addition, the GAO found that some businesses face obstacles in using the tax benefits, such as not knowing about them, finding them too complicated, not qualifying for them, and not having federal tax liability.[8]

While the GAO found that the impact of the tax incentives portion of the EZ program is un-measurable, un-auditable, and thus unaccountable, EZ administrators – those closest to the program - are clear that the tax incentives by themselves have a negligible impact, at best, on community revitalization, and are clearly useful only in conjunction with other direct spending.

Other Limitations of Tax Incentives Strategies

While tax incentives might offer marginal benefits to businesses, they cannot reliably address the majority of issues that compound distressed community's problems. Most older, distressed communities have brownfields, small lot sizes and scattered property ownership that forces constraints on land assembly for development, low educational levels of working age residents, chronic unemployment, inadequate infrastructure for 21st Century businesses, poor markets for retail, etc. These are issues that few federal tax incentives can address – they are issues best resolved through direct investment. Thus, tax incentives can be used in conjunction with other public investments that seek to directly address those issues, but they cannot be a substitute for direct investment.

The Proposal

The Summit of Empowerment Zone Directors believes a more effective federal approach to community redevelopment would lie in a more balanced approach between tax policy and direct federal spending.

The Summit believes that the huge federal tax expenditures on the incentives should be reduced, thereby creating a funding stream for the more effective direct spending programs.

Impact of The Proposal Relative to Current System

This issue of the relative ineffectiveness of tax incentives to revitalize communities is of tremendous importance. It is a relatively new approach that is tremendously expensive, and, to date, the evidence suggests it is not effective.

This is of particular concern, when current community revitalization proposals call for an expansion of the tax incentives approach, and a diminuation of direct federal spending on revitalization. Recent federal efforts have focused on tax-incentives only programs for Renewal Communities and Round III Empowerment Zones[9], and the current White House

[8] U.S. General Accounting Office, *Community Development: Businesses' Use of Empowerment Zone Tax Incentives, GAO/RCED-99-253* (Washington, DC: September 1999). Report based on a survey of businesses operating in the original nine Round I EZs.

[9] The Community Renewal Tax Relief Act of 2000 authorized 9 Round II Empowerment Zones and 40 Renewal Communities. Both of those designations are tax incentives-only revitalization programs.

budget proposal calls for an overall decrease in grant funding for community development and an increase in tax incentives for community development.[10]

According to the U.S. Department of Commerce, the proposed Strengthening America's Communities initiative is designed to create tax incentives only "Opportunity Zones," a new Single Family Homeownership Tax Credit, reduce direct federal spending on community revitalization by approximately 35%, and increase overall federal treasury losses to tax incentives by nearly $1 billion per year.[11]

In contrast, direct spending by the federal government, rather than hiding spending in arcane provisions of the U.S. Tax Code, accomplishes a number of critical public policy objectives:

- It channels federal effort away from unaccountable areas not subject to the bright light of public scrutiny, into highly accountable direct spending program with visible and measurable results.
- It removes hidden subsidies, and provides for a more direct funding of critical domestic American needs such as job training for high demand occupations and new investment.
- It reduces total federal outlays on community redevelopment, while improving the outputs of that federal spending.

Transition, Tradeoffs and Special Issues

There are relatively few costs of enacting the proposal, other than relatively marginal costs to individual businesses from the absence of the federal subsidies. This proposal recaptures a portion of the $6.9 billion projected to be lost to the federal treasury due to these tax expenditures under the EC, EZ, and RC programs. These dollars would be collected by the Treasury Department, and a portion of these newly-collected funds should be used to fund the previously under-funded locally-developed Round II Empowerment Zones. The remainder of the funds can be used for any number of priorities, including contributing to a reduction in overall tax rates, federal deficit reduction, or other federal priorities.

While there are many good reasons to provide tax relief to businesses, a tax incentives-only strategy for community redevelopment simply does not work. It takes a combination of appropriate incentives along with direct spending to effectively revitalize America's most challenging areas. The Summit of EZ Directors advocates for a reduction in community redevelopment tax expenditures, in order to better fund direct spending programs.

[10] Office of Budget and Management, *The Budget of the United States Government, Fiscal Year 2006.*

[11] U.S. Department of Commerce: *Strengthening America's Communities Initiative, An Overview* (Washington, DC: February 2005)

The Summit of Empowerment Zone Directors appreciates this opportunity to provide input to the President's Advisory Panel on Federal Tax Reform. We would be pleased to provide further information upon request.

Sincerely,

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