

Eliminating Enterprise Zones in California: An Analysis of the Proposed Budget and Its Effects on California Businesses

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The proposed budget for the State of California (the "Proposed Budget"), which was released on January 11, 2011 by Governor Jerry Brown, calls for the elimination of State Enterprise Zones ("EZs"). EZs are economically distressed areas that have been targeted for economic development and revitalization. Businesses that locate within EZs are eligible for certain state tax benefits, including hiring credits, wage credits, credits for sales taxes paid on purchases of certain machinery, exclusions of interest earned on qualifying loans to businesses, and expensing of qualified business investments. Currently, there are 42 EZs located throughout California. Though the designations are generally for a 15-year period, some EZs have recently received extensions. The Proposed Budget would eliminate all EZ and similar tax incentives for tax years beginning on or after January 1, 2011.

As with other aspects of the Proposed Budget, the elimination of EZs is extremely controversial. At a time when unemployment in California is at near-record highs, business owners across California are concerned that they will lose benefits afforded to businesses in EZs, and many are projecting higher business costs. Although there is no way to know how the proposal to eliminate EZs will ultimately fare, it is reasonable to expect the proposal to undergo several changes over the next few months and possibly be challenged in court.

Summary of the Proposed Budget's Elimination of EZs

EZs are afforded a wide array of benefits ranging from hiring credits to interest deductions. The Proposed Budget would eliminate all EZ tax incentives and similar tax incentives for specific areas, including EZs, Targeted Tax Areas, Manufacturing Enhancement Areas, and Local Agency Military Base Recovery Areas, for tax years beginning on or after January 1, 2011. These tax benefits would be eliminated for newly earned credits and deductions as well as for credits that have been earned in prior years but have not yet been used. Any recent redesignations or extensions of existing EZs would be reversed, and future redesignations would be prohibited. Local agencies that desire to maintain any local incentives could continue to do so. According to the Proposed Budget, the elimination of EZs would generate additional revenues of \$343 million in fiscal year 2010-2011 and \$581 million in fiscal year 2011-2012.

According to the Proposed Budget, EZs have little impact on the creation of new economic activity or employment. One report states that there is "no statistically significant effect on either employment

levels or employment growth rates" within EZs as compared to neighboring areas. Other reports contain similar findings, noting that EZs are mildly effective in increasing economic activity within smaller geographic areas, but that the increases are not large enough to materially affect the local economy. In addition, the reports state that increases are often not the result of new activity but rather are from the shift of activity into a zone that otherwise would have occurred elsewhere. The Governor also argues that EZs do not always cause businesses to relocate or expand because many businesses that ultimately benefit from EZ incentives were already located within EZ boundaries. As evidence that the EZ benefits do not independently draw businesses to EZs, the Governor points to the firms that specialize in finding businesses that can benefit from their location within an EZ and prepare those businesses' tax returns on a percent-of-benefit basis. Many businesses, he argues, do not even know that they are eligible for the benefits until they are told so by these firms.

In addition to the reported inefficacy of EZs, the Proposed Budget frames their elimination as part of an overall realignment in the way funding of local development efforts is achieved. Many changes in the Proposed Budget are intended to shift the responsibility and the authority for local development efforts to the local jurisdictions and their voters. Moreover, because the primary benefit of these zones is to shift economic activity from one geographic region within California to another, the Governor argues that EZs are not of statewide benefit.

Reaction to the Proposed Budget's Proposal to Eliminate EZs

Due to the long and rigorous legislative process involved in finalizing a state budget, the Proposed Budget is unlikely to remain intact until its final approval. Since its release on January 10, the Proposed Budget's EZ proposal has generated a flurry of discussion, articles and blogs. Business groups have characterized the proposal as inconsistent with policies that promote economic development and job growth. They also argue that because EZs represent a commitment from the state and a significant investment from local governments, the proposal to eliminate EZs is diametrically opposed to the Governor's stated goal of empowering local jurisdictions to take on local development.

Interest groups are also concerned that the elimination of EZs will adversely affect California's already dismal job situation. In a January 11, 2011 statement, the California Association of Enterprise Zones stated, "[t]ax increases and the elimination of these important economic development programs will only worsen California's unemployment rate and cause more businesses to flee to states with healthier economies and friendlier business policies."

In addition to job losses, some business owners are already predicting increased costs of doing business. According to a Fontana businessman, "[e]verything we do will cost more. How much we change what we do; only time will tell." Businesses that have taken advantage of the EZ tax benefits in the past and expected the benefits to continue may be forced to revise their business strategies to cope with the unexpected elimination of EZs.

Not everyone is opposed to the Governor's plans, however. Some support the Governor's attempt to reduce the budget shortfall and several studies suggest that the benefits of EZs are outweighed by their costs. A report by the W.E. Upjohn Institute for Employment Research concluded that since many of the benefits of EZs are jobs that would have been created anyway, state and local government will see a net loss of \$60,000 for every job created in an EZ. The Proposed Budget cites several studies which suggest that the costs associated with EZs do not equate with the value that they bring to business and development ventures because many such ventures would have gone forward even

without the benefits of EZs. An editorial in *The Oakland Tribune* dated January 21 cites many of the same studies and concludes, “[i]f the enterprise zones were an important element in the overall business and jobs growth in California, it would be a mistake to end the tax breaks. But study after study has shown that is not the case.”

Conclusion

The widespread and powerful opposition from business leaders and municipalities to the Proposed Budget’s elimination of EZs will likely affect how EZs fare in the final budget. Considering this opposition and the impact that this proposal would have on businesses and development, the debate over the Proposed Budget should be closely monitored.



If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings lawyers:

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