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on
Tax Incentives in the Aftermath of Hurricane Katrina

Mr. Chairman and Members of the Committee, I am Jane G. Gravelle, a Senior Specialist in Economic Policy in the Congressional Research Service of the Library of Congress. I would like to thank you for the invitation to appear before you today to discuss tax proposals for economic rebuilding in the aftermath of Hurricane Katrina. Although I discuss options and approaches, please note that the Congressional Research Service takes no position on legislative options.

I would like to discuss the following issues. First, what potential assistance can the federal government offer, and what past examples of geographically targeted incentives exist? Second, what is the economic efficiency rationale for U.S. government involvement in the aftermath of Katrina? Third, what evidence exists for the success of geographically targeted programs, and is this evidence relevant to Katrina? Fourth, what are the implications of the efficiency rationale for the design of tax incentives? And finally, what role can tax incentives play, and how might they be designed to be most effective?

Alternative Approaches to Providing Assistance

Government assistance for rebuilding may involve two types of policies. One is grant assistance. This assistance can be provided to public entities to rebuild the public infrastructure (roads, schools, etc.) which might include port facilities that were formerly privately owned and might include reconstruction of low income housing. Grants, or other assistance, such as credit subsidies, could also be provided to private individuals and businesses. An alternative policy is to provide tax subsidies for private firms. Tax subsidies could also be provided to individuals, for example, to rebuild their homes. Mortgage revenue bonds are an example of tax subsidies directed at homeowners rather than businesses. Expansion of some of these provisions has already been enacted in the recent tax legislation.

Tax incentives have the advantage of working via market processes, so that the individual additional investment is the most productive of the investments that otherwise would not be made. If subsidies are directed at a specific market "failure,"[1] however, the lack of specific control by the government may be a disadvantage. Other problems with tax subsidies are their potential lack of availability to firms and individuals without tax liability, the difficulty in making less sophisticated firms and individuals aware of the provisions, and the additional administrative complexity in the tax code. Grants or loan subsidies can be targeted to specific uses and might be appropriate for addressing certain types of external effects. A disadvantage of grants and loan subsidies is the bureaucratic process required and the lack of information available to government officials about optimal investments. In both cases, lag time can be a problem.

Current Geographically Targeted Tax Provisions

In his address on September 15, the President's proposals included a proposal for a Gulf Opportunity Zone that would provide tax subsidies to businesses. Such provisions might be modeled on current enterprise zone provisions.

The main examples of past tax legislation to address disasters are the Liberty Zone provisions adopted in 2002 for the area in lower Manhattan that was affected by the terrorist attacks. These provisions included expansion of the Work Opportunity Tax Credit (WOTC) for small employers, accelerated depreciation for equipment investments and leasehold improvements, increased private activity bonds (which are generally limited by a state cap) and favorable treatment of capital gains realized from the replacement of property. These provisions were originally made available for a few years (varying by incentive), but were extended in most cases through 2010.

Current tax law contains other geographically targeted provisions often referred to as enterprise zones. (Many states have enterprise zone programs as well.) They comprise 40 empowerment zones (30 urban and 10 rural), 95 enterprise communities (65 urban and 30 rural), and 40 renewal communities. Tax incentives for empowerment zones include a 20% employer wage credit for the first $15,000 of wages for zone residents who work in the zone, an additional $35,000 (above the $100,000 generally allowed) in expensing of equipment investments of qualified zone businesses, and expanded tax exempt financing for certain zone facilities. Renewal communities are allowed a 15% wage credit on the first $10,000 of wages, the additional $35,000 in capital expensing, and partial expensing of qualified buildings. Enterprise communities receive tax exempt financing benefits. Schools in enterprise communities and empowerment zones are also eligible for qualified zone academy bonds, where the federal government effectively pays the interest on the bonds. These areas are also eligible for special benefits for cleaning up environmentally contaminated areas (brownfields). There are also special provisions for Indian reservations and the District of Columbia. There is also a new markets tax credit for investors, equal to 5% of the original

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[1] Market failure is a common term in economics and it refers to circumstances where markets do not work with full efficiency, or where there are external costs and benefits that are not priced. An example is the negative effects of pollution.

investment and for the next two anniversary dates, and a 6% credit for the following four anniversary dates, along with capital gains tax benefits for investors.

New Orleans already has a renewal community designated area, the New Orleans/Jefferson area, on the Mississippi River west of the French Quarter, but it is only a part of the city. There is also a renewal community in Mobile, Alabama. The Treasury has announced that it will give additional consideration to approving new markets coverage for organizations that target their investments to the disaster areas.

These measures indicate the types of geographically targeted tax incentives that have been and are now being allowed: wage credits, accelerated depreciation, tax exempt bond expansion and tax subsidized bonds. There are other options, however, that might include an expansion of the tax credit for rehabilitation of older buildings. This type of provision might be more appropriate for a city with a significant tourism business like New Orleans, whereas lower Manhattan was primarily a financial center.

States adopted enterprise zones well before the federal government did so in 1993. The enterprise zone idea began in the U.K. and many states have since adopted enterprise zones. The earliest state programs began in Florida and Louisiana.[2]

The recent tax relief bill, H.R. 3768 (The Katrina Emergency Tax Relief Act of 2005, P. L. 109-73), signed by the President on September 23, already contains some measures of these types. It allows a WOTC for individuals affected by the hurricane (through 2005 for employers outside the area and through August of 2007 for employers inside the disaster area), along with an employee retention credit, but limited to firms with no more than 200 employees. It also includes a number of provisions providing benefits to property owners. It allows tax exempt mortgage revenue bond financing for current homeowners (these bonds are currently only available to renters) and increases the limit from $15,000 to $150,000 for home improvement loans. It excludes income from the cancellation of indebtedness. The two most significant items (based on revenue costs) are the elimination of casualty loss deduction floors and allowing an extended period of time to avoid gain recognition for involuntary conversions.[3]

Justification for Subsidies

There is a considerable economic literature discussing both the justifications for geographically targeted subsidies to private business and assessing the effectiveness of these subsidies. In general, economic theory suggests that private market incentives in most cases make subsidies unnecessary or not efficient. Private rebuilding should occur in the absence of tax subsidies, although government construction of essential public infrastructure, such as roads, is vital to any area's recovery. The issue is what speed or magnitude of rebuilding is desirable. Normally the need for subsidies would occur either to achieve distributional

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[2] See Margaret G. Wilder and Barry M. Rubin, "Rhetoric versus Reality: A Review of Studies on State Enterprise Zone Programs." *Journal of the American Planning Association*, Vol. 62, Autumn, 1996, pp. 473-490.

[3] Other provisions included charitable giving incentives, tax free withdrawals from IRAs and pension plans, exemptions for sheltering victims, and qualifying for the earned income and child credits based on 2004 income.

objectives or because of market failures — circumstances where an efficient allocation of investment does not occur because of unpriced costs.

The issue often addressed in the economics literature, reflecting the normal goal of enterprise zones and similar policies, is not about rebuilding a devastated area, but about encouraging development in areas that are chronically depressed. There are two efficiency reasons that are commonly given for this intervention. One is that there is a mismatch between available labor supply, and the businesses that need employees — an argument that in general would apply to urban areas, not rural ones. For example, businesses in some outlying areas of the city may find it difficult to locate employees, while unemployment in the inner city may be high. This mismatch causes lower income in the city as a whole and a lower tax base. If transportation costs or lack of knowledge creates a barrier to mobility around the city, one approach is to try to develop the inner city to create jobs for residents. There are, of course, alternative policies, such as providing job matching services and subsidized mass transit for residents of low income areas, or providing low-income housing in areas of the city that are more prosperous. For a variety of reasons these alternatives may not be accepted by the city residents. In addition, city transit systems may not be designed to transport workers out of the central city. Thus, the option of trying to stimulate development in the depressed area may be chosen.

A second efficiency argument is that depressed areas tend to breed more crime which imposes costs on society (both from being a victim of crime and from paying for the resources such as police and prisons needed to deal with crime). This argument might apply to both rural and urban areas.

In either of these cases, the objective is to provide jobs for residents of depressed areas. That rationale suggests that tax subsidies provided should be in the form of wage subsidies, which are more likely than subsidies for investment to produce jobs. Under certain circumstances capital subsidies could actually decrease employment by encouraging labor saving investments. Yet many of the subsidies provided in these geographically targeted areas are subsidies for capital investment.

There is also a concern that the resources drawn into the enterprise zones will be those from a contiguous area that also tends to be poor, since the closest substitutes for businesses within an enterprise zone are the businesses that are located in close proximity.

A second objective is redistributional — to help poor people. The difficulty with this argument is that there is no obvious reason to concentrate government help on poor people who live in the poorest neighborhoods and exclude equally poor people who do not.

There is also the issue of whether intervention should be provided by the federal government or the state government. If the motive is efficiency then the source of funds might depend on who is bearing the costs of that inefficiency, and in the case of revenue base and crime may include both taxpayers in the states and localities and taxpayers across the national in general. If the motive is distributional, then there is more of a case for a national effort, particularly in the case of Hurricane Katrina since the states and localities involved have lost much of their revenue base as well.

In the case of the rebuilding of areas devastated by Hurricane Katrina, the question is whether the standard arguments for enterprise zones can be applied to rebuilding areas that are not (at least in their entirety) chronically depressed, but have been destroyed by a natural disaster. It is not clear that they can be. Rather, the principal justification for intervention may be largely distributional — the desire to help people who have faced a significant loss to reclaim their lives.

A different efficiency objective may also be invoked in the case of major disasters: aid to devastated areas by the federal government may be viewed as an implicit form of insurance — the country as a whole acts to spread the risk of the cost of natural disasters. If there are imperfect markets for catastrophic insurance, then aid in rebuilding is needed to achieve an efficient allocation of resources. In particular, the cost to businesses in a catastrophe exceeds the loss of property (which can be covered by insurance) because the business also loses its customer base and work force, and it is difficult for private insurance markets to provide coverage for this type of loss due to problems such as moral hazard[4] (behavioral response on the part of the insured) and adverse selection (since insurance companies are not as fully informed about the health of the companies as the companies themselves, they would expect the companies with inferior prospects to constitute more of their customers and price the insurance too high for the average firm).

Providing relief to businesses affected by disasters by the government can also, however, create its own moral hazard if provided in cases where firms could have been insured (e.g. property insurance). Viewed from this perspective, relief should be limited to extraordinary disasters.

Another potential rationale for rebuilding, especially in New Orleans, is the value of the unique cultural heritage embodied in the city. The existence of a unique city can be said to provide benefits to the country as a whole, even those who may not visit, much as the presence of the Grand Canyon or national parks. It provides value in the option for visiting and a cultural backdrop for novels, movies, and other entertainment media.

Finally, relief may be provided to the region as a part of the risk spreading (across time and across individuals) that is part of the general social safety net, similar to the justifications for Social Security.

Evidence on the Effectiveness of Geographically Targeted Incentive Provisions

State and local zone programs have been around for a longer period of time than have federal programs, and provide most of the basis for empirical studies. While they provide subsidies to both labor and capital, most of these programs tend to rely more heavily on investment subsidies.[5] They have also commonly tended to provide subsidies for zones in urban areas.

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[4] Moral hazard is another common term used in economic analysis and is a common insurance problem. A standard example is not allowing fire insurance for more than the value of the property, which provides an economic benefit to destroying one's own property. There are more common examples, however, such as unnecessary visits to the doctor when an individual has extensive health insurance.

[5] See Leslie Papke, "Enterprise Zones," in *The Encyclopedia of Taxation and Tax Policy*, ed. Joseph J. Cordes, Robert W. Ebel, and Jane G. Gravelle (Washington, D.C.: The Urban Institute, forthcoming 2005). An earlier version is available in the 1999 edition of the encyclopedia.

Evidence on the effectiveness of subsidies is unclear. There is a significant body of empirical studies focused mainly on state enterprise zones; in general, most of these studies have not found evidence of effects on growth or employment.[6] These results do not necessarily mean that there are no positive effects, but rather that the effects are small and difficult to detect statistically. Specific evidence of the empirical effect of federal programs is virtually non-existent and although some studies have found effects, there are some reservations about their methodology.[7]

The U.K., which began the enterprise zone approach (but focused on industrial zones rather than communities), is now allowing the zones to expire after concluding that the source of new activity was relocation from other areas.[8]

The studies, largely from state enterprise zones, constitute the body of empirical evidence available to assess effectiveness. These results, however, may not be very meaningful for measuring the potential effect of aid to rebuild the disaster area. For example, it is possible that depressed areas are so unattractive for business entry that subsidies cannot exceed the threshold to entice new business in, while a subsidy for a less depressed area may do so.

One difference for rebuilding of larger areas of cities, or entire cities, is that it is less likely that any induced investment or growth would come at the expense of other poor communities, since these incentives are not specifically targeted at chronically distressed areas. Rather the investment would be diverted from other uses in general.

Moreover, to the extent that the risk sharing rationale is the argument for providing assistance, the aid may serve its purpose even if it does not induce additional investment. The most important effect might be to lead to a more efficient allocation of investment in the country in general because the expectation of assistance in the event of a major disaster offsets the lack of an actuarially fair insurance market.

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[6] For a brief review, see Leslie Papke, "Enterprise Zones," op. cit. See also Robert T. Greenbaum and John B. Engberg, "The Impact of State Enterprise Zones on Urban Manufacturing Establishments," *Journal of Policy Analysis and Management*, Spring 2004, Vol. 23, pp. 315-339, for a review of the evidence. The authors in this study found very little average effect, but a positive effect on new establishments and a negative effect on existing ones. A more positive outcome was found in a new study of Mississippi enterprise zones. See Jim F. Couch, Keith E. Atkinson, and Lewis H. Smith, "The Impact of Enterprise Zones on Job Creation in Mississippi," *Contemporary Economic Policy*, Vo. 23, April, 2005, pp. 255-260. A more detailed review of some earlier studies can be found in Wilder and Rubin, "Rhetoric versus Reality: A Review of Studies on State Enterprise Zone Programs," op. cit. Other reviews include Don Hirasuna and Joel Michel, "Enterprise Zones: A Review of the Economic theory and Empirical Evidence, " Policy Brief, Minnesota House of Representatives Research Department, January 2005; Cynthia L. Rogers and Jill L. Tao, "Quasi-Experimental analysis of Targeted Economic Development Programs: Lessons from Florida," *Economic Development Quarterly*, Vol. 18, August 2004, pp. 269-285; Daniele Bondino and Robert T. Greenbaum, "Decomposing the Impacts: Lessons from a Multistate Analysis of Enterprise Zone Programs," John Glenn Working Paper Series, The Ohio State University, Working Paper, June 2005.

[7] See General Accounting Office, *Community Development: Federal Revitalization Programs Are Being Implemented, but Data on the Use of Tax Benefits Are Limited*, GAO-04-306, March 2004.

[8] See Leslie Papke, "Enterprise Zones, " op. cit.

There is some very limited evidence on the WOTC in general. A concern about the program has been the possibility of churning employees to repeat the credit. There are some reasons to believe this churning problem is not serious, but there is also some limited information that suggests the WOTC does not have much effect on hiring decisions.[9]

Implications of the Efficiency Rationale for General Focus of Tax Incentives

The design of tax incentives depends partly on the justifications for rebuilding. The traditional enterprise zone focused on creating jobs and increasing labor demand in depressed areas of the city would, at least in theory, be most likely to expand employment if labor subsidies are used. There is no particular reason to limit the incentives to firms that are already present in the area, as attracting new firms may be as important as expanding old ones. Nor is there a particularly reason to focus on small businesses as opposed to large ones.

If the rationale is, instead, to spread the risk caused by localized disasters to the country as a whole, and to focus that risk spreading on the businesses most affected by the disaster, the implications for design are quite different. First, to address the concerns of a range of different types of businesses, some of which are labor intensive and some of which are capital intensive, a range of subsidies might be more appropriate. The subsidies might be particularly focused on businesses that existed prior to the disaster, and also on businesses whose activities (measured, for example, by gross receipts) are concentrated in the disaster area. This design implication suggests that small businesses would be more likely to qualify since such businesses would, by their nature, tend to have more of the receipts concentrated in a single area. Nevertheless, the rationale would not preclude including larger businesses with more employees or a larger asset base. In addition, since the problem with an area wide disaster for business activity extends beyond property damage to the loss of a customer base and a labor force, subsidies to address issues such as housing may also be appropriate.

Based on the rationale of the preservation of the cultural heritage, especially in the New Orleans area, subsidies might be directed towards the construction or reconstruction of historic buildings, which would be accomplished via several mechanisms. It may also suggest that subsidies directed at the service sector might be appropriate.

The Specific Design Issues

Tax subsidies can be provided directly to the target, as in the form of investment subsidies, general tax relief, and wage subsidies for businesses to rebuild. They can also be provided indirectly through private activity tax exempt bonds and programs like the low income housing credit, whose target is not the business itself, but renters, and the new markets credit. They should, of course, have a time limit, but it is difficult to determine what that time period should be.

There are several important observations that might be made about specific design issues.

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[9] See the discussion of the WOTC in U.S. Congress, Committee on the Budget, United States Senate, *Tax Expenditures: Compendium of Background Material on Individual Provisions*, Senate Report 108-54, Washington, DC, U.S. Government Printing Office, Dec. 2004, p. 493.

Direct Investment Subsidies

Investment subsidies reduce the cost of investing. These can be provided through programs such as bonus depreciation and investment credits. It is important, however, to be aware of the magnitude of effects. The value of provisions such as expensing and bonus depreciation depend on the standard depreciation rules. Bonus depreciation is neutral across assets as it proportionally lowers the required rate of return to be a desirable investment. But its magnitude can be small in some cases because the return for short lived property is not a large fraction of the cost. Fifty percent bonus depreciation, for example, is the equivalent, at a tax rate of 35%, to a 2% price reduction for five-year property and a 3% price reduction for seven year property. (The benefits of expensing would be twice as large). The magnitude of benefits is relatively small because the present value of standard depreciation deductions is large and the speed up's value is small relative to asset cost. If 50% bonus depreciation were extended to structures or structural repairs, the benefit would be 12%. If a larger subsidy is desired, an investment credit might be employed.

For capital subsidies, the largest "bang for the buck" tends to come from investment subsidies, rather than tax relief for the return to existing capital (such as lower capital gains rates).

Tax subsidies, in the absence of refundability, benefit only those firms with tax liability. Firms may also not benefit if they have significant carryovers of past losses or credits. Since these firms may not do well in the current or future tax years, a possible revision is to extend the loss carryback period. This extension could be either a simple increase, or an option to elect a longer carryback period and a shorter carryforward period.

Wage Subsidies

The WOTC has already been provided for small employers in the recent tax bill. One important issue is whether the subsidy should be expanded to larger employers who were already present in the area and derived most of their income from the area, a change that is consistent with the insurance rationale.

Indirect Subsidies

Businesses that do not have tax liability can benefit from indirect subsidies that are channeled through taxable investors. There are three types of provisions that might be considered: private activity tax exempt bonds, low income housing credits, and new market tax credits.

One provision that can funnel subsidies to businesses without tax liability is an expansion of private activity tax exempt bonds. Tax exempt bond financing is generally available to State and local governments for financing public capital such as schools and roads. Private activity bonds involve borrowing by the state and local governments and then providing the proceeds to private investors, without a general obligation to pay interest and redeem the bonds if the project fails. Essentially this activity produces a tax subsidy (in the form of lower interest rates); without limits it could become an unlimited subsidy for all private investment. As a result, Congress has limited these private activity bonds to specific uses and to small issues, with volume caps applied by state.

However, providing subsidies through private activity bonds involves a certain degree of inefficiency as they involve intermediaries (which may make them less efficient and can produce windfall gains to high income investors). The exemption of tax on the bond interest allows states to provide funds at a lower rate, but it also tends to create excess returns to high tax rate investors. An alternative to expanded tax exempt bonds, although not a tax program, is to provide direct low cost loans.

Private activity bonds also essentially use federal funds but allow control to rest in the hands of state and local authorities, an outcome that may or may not be desirable.

If additional authority is allowed, it is not clear what the magnitude should be or how long it should be allowed. New York City has not been able to use all of its bond authority. The bond authority might be tied to the needs, but it may also be informative to consider the general magnitude of ongoing activity. According the latest census data for 2001-2002, the state and local governments of Louisiana had approximately $21 billion in total outstanding debt, and $7.5 billion for private purposes. The state and local governments of Mississippi had approximately $10 billion of debt, with $2.6 billion for private purposes. The state and local governments of Alabama have $19 billion of debt and $3.9 billion in private activity bonds.

A second type of tax provision that provides indirect benefits to those who do not have tax liability is the low income housing credit, which provides significant credits to investors for property when a certain fraction is rented to lower income individuals. As with tax exempt bonds, the state and local governments exercise control. There has been a lively debate in the economics literature about the efficiency of this provision, particularly as compared to alternatives such as rent vouchers.[10] In the short run, rent vouchers may simply bid up housing prices but in the long run, direct construction or supply subsidies may displace housing that would otherwise exist. As in the case of tax exempt bonds, one problem with the subsidy is that the projects are complicated to organize and there may be significant overhead costs. Another is that the investors may receive windfall benefits. Some critics charge that the low income housing credit is part of the corporate tax shelter problem and that investors receive very high returns. Some studies have suggested that states lack complete information on a significant fraction of projects.

Another type of tax benefit that does not directly provide benefits to businesses in the area is the new markets tax credit, which allows investors to receive credits for investments in community development authorities in poor areas. The new markets tax credit is so new that little information is available, but it is likely to suffer from similar problems to the indirect mechanisms above: the possibility of excess returns to investors as well as administrative overhead.

In general these indirect mechanisms involve a tradeoff: they can potentially direct funds to recipients who could not receive tax benefits directly and they use private market

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[10] The following discussion is based on Leonard E. Burman and Alastair McFarlane, "Low-Income Housing Credit, in *The Encyclopedia of Taxation and Tax Policy*, ed. Joseph J. Cordes, Robert W. Ebel, and Jane G. Gravelle (Washington, D.C.: The Urban Institute, forthcoming 2005). An earlier version is available in the 1999 edition of the encyclopedia.

mechanisms to some extent, but they also involve administrative overhead and may compensate private investors excessively.

Conclusion

Tax subsidies may play a role in rebuilding the Gulf area and may be justified on several grounds, all of which suggest a range of possible types (for labor and for capital). Evidence from state experience with empowerment zones does not support significant effects, but this evidence, relating to investment in chronically depressed areas, may not be relevant for rebuilding after a disaster. One of the significant challenges with tax policy, particularly in an economically devastated area, is that many of the businesses may not have adequate tax liability to benefit from the provisions. There are some ways of overcoming this problem. One is to extend the loss carryback period. There are also some novel approaches (such as allowing refundable credits, or offsetting payroll taxes) but these approaches have generally not been used in the income tax system and there may be concern about setting precedents. The other approaches, of allowing indirect subsidies (such as private activity bonds) may circumvent this problem, but may also involve significant administrative costs and windfall benefits to investors.