Taxing Simply

District of Columbia Tax Revision Commission

Taxing Fairly

Full Report

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All views expressed in this report are those of the author. These views are not necessarily shared by the staff or members of the D.C. Tax Revision Commission or by Tax Analysts.

CHAPTER D

D.C.: A Capitalist City?

A Preliminary Analysis of the New Federal Tax Incentives for the District of Columbia

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Introduction

A SUMMARY OF THE NEW TAX INCENTIVES

On August 5, 1997, President Clinton signed into law the *Taxpayer Relief Act of 1997*. The Act provides a net tax cut estimated to be $275 billion over 10 years — the first significant tax cut since 1981. One component of this tax reduction package was a set of tax incentives uniquely available to District residents and businesses operating in certain impoverished areas of the District. According to official estimates, the Act provides the District total federal tax relief of approximately $1.2 billion over the 10-year period from 1998 to 2007.[1] There are five parts to the District's tax relief package:

(1) Wage credit. A tax credit of up to $3,000 per employee will be available for wages paid to any District residents by businesses operating in areas of the District with poverty rates of 20 percent or more. Wages paid during calendar years 1998–2002 are eligible.

(2) Tax-exempt financing. The District has the authority to issue enterprise zone facility bonds for businesses operating in areas of the District with poverty rates of 20 percent or more. These tax-exempt financing bonds can be issued during the period after December 31, 1997, and before January 1, 2003.

(3) Faster write-offs. Small businesses operating in areas of the District with poverty rates of 20 percent or more will have an additional $20,000 of first-year deductions for expenditures on capital equipment. The additional first-year deductions will be available for qualified businesses for taxable years beginning after December 31, 1997, and ending before January 1, 2003.

(4) Zero-percent capital gains rate. A zero-percent capital gains rate will be available to investors who have owned for at least five years business property used in areas of the District with poverty rates of 10 percent or more, or who have owned a business operating primarily in areas of the District with poverty rates of 10 percent or more. To qualify for the zero rate, an investment must be paid for in cash after December 31, 1997, and before January 1, 2003.

(5) Homebuyer credit. Starting on August 5, 1997, a tax credit of up to $5,000 is available for couples with incomes below $130,000 (and singles with incomes below $90,000) making their first purchase of a home anywhere in the District. (An eligible taxpayer may currently own a home as long as it is not in the District.) This credit expires on December 31, 2000.

In addition, two tax benefits will become available to District businesses as a result of the District's new status as an empowerment zone:

(6) Brownfields. Businesses operating in areas of the District with poverty rates of 20 percent or more will be able to deduct environmental clean-up expenses in the year these expenses are incurred. Under current law, these expenses often could not be deducted at all. (Urban sites contaminated with hazardous substances are commonly referred to as "brownfields.") These special deductions are available for expenditures incurred in the years 1997–2000.

(7) Work opportunity tax credit. District employers can earn a tax credit of up to 40 percent on wages paid to high-risk youths (ages 18–24) and qualified summer youth employees (ages 16–17) as long as these employees reside in areas of the District with poverty rates of 20 percent or more. In general, the credit is available for the first $6,000 of wages paid to each employee. This credit is available only in the District during the first six months of 1998.

Under the *Taxpayer Relief Act*, the Census tracts of the District with poverty rates of 20 percent or more are collectively referred to as the "District of Columbia Enterprise Zone."[2] As the name suggests, there are a lot of similarities between the new federal tax incentives for the District and the tax incentives available under current law in federal empowerment zones and enterprise communities around the country. But there are significant differences as well. There are more types of tax incentives available in the D.C. enterprise zone than in empowerment zones generally. Moreover, some of the tax incentives are available in an expanded version of the zone (i.e., in Census tracts with poverty areas of 10 percent or more), and some are available in the entire District.

GEOGRAPHY — A PATCHWORK QUILT

Of all the new tax incentives for the District, only the first-time homebuyer tax credit is available in all parts of the District.[3] The availability of the other new tax incentives for the District varies across neighborhoods.

The availability of tax incentives in any particular part of the District depends upon the level of poverty in that area. As with all major cities in the United States, the U.S. Census Bureau has divided the District into small, neighborhood size areas called Census tracts. A Census tract generally has a population of 2,500–8,000 residents. The new federal legislation in effect creates three classes of Census tracts: (1) Census tracts with poverty rates between zero and 10 percent, (2) Census tracts

Figure D-1

New D.C. Tax Benefits Vary According to Poverty Level of Census Tract

At Least 10% Poverty	At Least 20% Poverty	Entire District: No Poverty Requirements
• 0% Capital Gains • Homebuyer Credit	• Tax-Exempt Financing • Additional Expensing • Homebuyer Credit • 0% Capital Gains • Wage Credits for Residents' Employers • Brownfields • Extra Work Opportunity Credit	• Homebuyer Credit • Wage Credits for Residents' Employers

with poverty rates of 10 percent–20 percent, and (3) Census tracts with poverty rates of 20 percent or more. In general, the Census tracts with the most poverty get the most tax incentives.

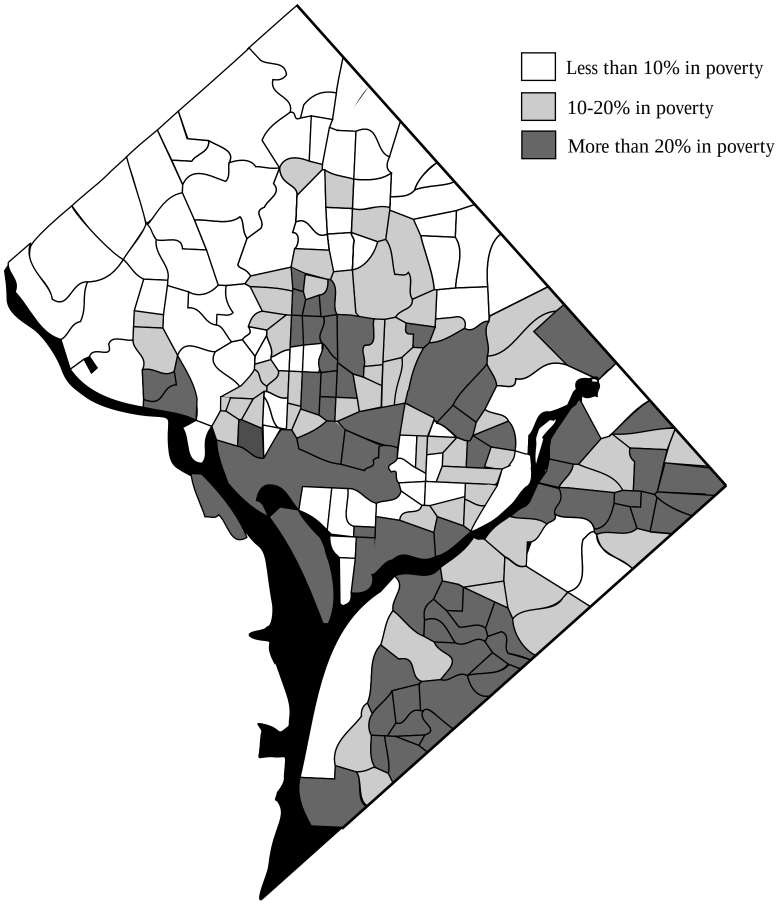
Only in the Census tracts in the District with poverty rates of at least 20 percent are all the new tax incentives available (including the "brownfields" provisions and additional work opportunity tax credits).[4] In Census tracts with poverty rates of 10 percent or more, only the zero-percent capital gains rate and the first-time homebuyer credit is available. The availability of various tax incentives by Census tract poverty level is summarized in Figure D-1.

Figure D-2 shows a map of the entire District and indicates the general level of poverty in each Census tract. As anyone generally familiar with the District might expect, the map indicates that many of northern and northwestern parts of the city have low levels of poverty. Of the all the new tax benefits for the District, the one with the most direct impact in these areas is the homebuyer credit. And among these Census tracts, the wealthier areas get relatively less from the homebuyer credit for two reasons. First, the flat credit amount is a smaller percentage of the price of a house for more expensive homes (i.e., the $5,000 homebuyer credit does not play as large a role in the purchase of a $500,000 house as it does in a $100,000 house). Second, by statute the homebuyer credit is not available to families with high incomes (i.e., the credit phases out over incomes of $110,000–$130,000).

And, as one generally familiar with the city might expect, much of the southeast and eastern portions of the city have significant levels of poverty, and accordingly,

Figure D-2

D.C. by Degree of Poverty



much of this area qualifies for all the new tax incentives. A new business in a 20 percent poverty area could get wage credits, additional first-year write-offs, and tax-exempt financing; and after five years the owners can sell their stock and pay no capital gains taxes.

But there are exceptions to these generalizations about poverty in the District. For example, a significant portion of the Georgetown area is eligible for the zero-percent capital gains rate, and in some parts of Georgetown all the new District tax incentives are available. Conversely, there are big pieces of the southwestern and southeastern District — particularly around Capitol Hill — that do not qualify for anything but the homebuyer credit.

But probably the most difficult area for deciphering the geography of tax benefits is the downtown business district and the areas immediately north of that. In the downtown area, a walk of a few minutes takes one through areas with three different sets of tax rules. In these areas, there often is no readily apparent reason (e.g., natural barrier, neighborhood identity) for having different sets of tax rules from one block to the next. For example, just a few blocks west of the White House, restaurants on one side of Pennsylvania Avenue are eligible for wage credits while restaurants on the other side are not.

Although the spottiness of tax regimes is particularly concentrated in the downtown areas, there is likely to be quite a lot of confusion for businesses and residents throughout the city. These new and unmarked (and mostly unknown) borders between Census tracts with different tax regimes are dozens of miles long. There are more than half a dozen intersections in the District where all three types of Census tracts form a common border.

Economic impacts of the tax incentives

INTRODUCTION

Even though Congress has devoted an estimated $1.2 billion of tax benefits to the District, there are no assurances that its intended objectives can be met. Unfortunately, nobody — inside Congress or out — has any reliable evidence on the efficacy of tax incentives available in the District.

The empirical economic studies on the effects of local tax incentives on local economic development show no consensus. Although economics may not be able to provide cut-and-dry quantitative impacts of how local tax incentives affect the local economy, economic reasoning can provide some useful insights. One of these is that targeted tax incentives are more likely to change behavior than are broad-based incentives. For example, it is easier to increase employment in a small area than it is to increase employment in a large area. This is because in order to increase employment in a large area, more new jobs must be created. Creating employment for a more targeted area can be achieved by either job creation or by moving employment from surrounding areas into the targeted areas.

Economics also can provide some insight into whether incentives are well targeted for achieving their objectives. For example, as discussed below, the homebuyer credit does provide an incentive for a "stable residential base" in the District in two ways: It encourages current middle-class District residents who are renting apartments to buy and it encourages middle-class nonresidents to move into the District and buy homes. The credit does not, however, encourage current D.C. homeowners to stay in the District. It does not provide an incentive for most low-income and most high-income families to buy a home in the District. And the credit does not encourage immigration of families and individuals who may want to rent instead of buy.

Economics also can provide some warnings about possible unintended side effects of some of the incentives. For example, as discussed below, the empowerment-zone wage credit provides incentives for employers to use more temporary workers and to substitute low-wage workers for high-wage workers. The credit also will encourage D.C. employers to favor hiring D.C. residents over nonresidents. The economic consequences of the new tax incentives for the District are highly uncertain; it is not known if these hypothesized side effects will actually materialize. It can be said from the outset, however, that targeted economic incentives like the wage credit — to the extent they affect economic behavior at all — are more likely to change the composition of economic aggregates rather than the total amounts. For example, it is much more likely that the wage credit will induce shifts in employment patterns in the regional economy than increase overall employment. Many of these possible shifts in the composition of the labor force may not be particularly helpful to the area economy.

THE WAGE CREDIT

The wage credit can reduce a business's cost of employing qualified employees by up to 20 percent.[5] The credit is available to employers for wages paid to any resident of the District that performs substantially all of his or her services in the D.C. enterprise zone (i.e., in Census tracts of the District with poverty rates of 20 percent or more). Because the credit applies to only the first $15,000 of wages paid to each employee each year, employers of low-wage employees are favored over employers of high-wage employees.

Potential impact on land values

The availability of the wage credit in some areas of the District could increase land values and rents in those areas relative to other parts of the District that are not eligible for the wage credit. The fact that so many employees qualify and relatively few areas of the District are eligible for the credit make this a likely possibility.

For example, suppose an office building on the south side of Pennsylvania Avenue (call it property Z) is in the D.C. enterprise zone while a comparable office building on the north side of Pennsylvania Avenue is outside of the zone (property N). If it is expected that the facility has space for 100 employees, of which 75 percent are expected to be District residents, the credit could be worth $225,000 (in pretax dollars) per year to a business that intends to lease that property. The capitalized value of the tax incentives over a five-year period is more than $1 million.

This is a significant value relative to the total value of the lease. If in the prior example the total size of the space being leased was 18,500 sq. ft., and the annual rental rate was $25 per square foot, the total annual rental cost would be $462,500. If the entire $225,000 of expected annual tax benefits can be captured by the property owner, there would be a 49 percent increase in rent.[6] The potential percentage increase in value would be greater for properties with lower rental costs per employee (i.e., for firms that pay lower rent per square foot or that put more employees in the same space).[7]

Whether or not the property owner can extract the full value of the tax benefits depends on market conditions. If there are several other private companies seeking to rent the same property (i.e., a "sellers' market"), and other properties with comparable characteristics are not available in the D.C. enterprise zone, the property owner may prevail in raising the rent. If, however, all the other potential lessors of that property cannot use the credit (i.e., they are nonprofit entities or most of their employees are nonresidents), it is unlikely that the property owner will be able to significantly raise the rent.

The value of the tax benefits will vary depending on the degree of labor intensity of the tenant, on the wages paid, on the permanency of the employees, and on the residence of the employees. In order to maximize their rents, property owners in the D.C. enterprise zone may wish to seek out employers of low-wage, high-turnover, labor-intensive businesses. For the next five years for which the zone designation is in effect, there may evolve a natural "sorting out" of tenants as governments and nonprofit organizations move out of the D.C. enterprise zone to make room for private business that can take advantage of the wage credits inside the zone areas.

Any increase in property value is a windfall to existing property owners in the D.C. enterprise zone, i.e., relatively well-off District residents and nonresidents get a benefit for having done nothing more than they would have done otherwise. This runs counter to the intent of any "targeted" tax benefit. Targeted tax benefits try to encourage new economic activity that is consistent with policy objectives (in this case, increase economic development in the District). To the extent that the owners are not residents of the District, the direct benefit for the District from higher property values will be limited to increases in property tax revenues. To the extent the owners of the property are residents of the District, the increased rents and capital gains should increase District income taxes. There may be some indirect benefits if the extra income generated by the higher land values (whether for District or nonresident owners) is spent on products and services generated in the District.

Wage credit-induced increases in property value in the D.C. enterprise zone will be an indicator of the credit's effectiveness in reducing unemployment. Higher real estate prices signal that the benefits of the credits are accruing to property owners and not to employers (who might boost employment by increasing the demand for labor) or employees (who might boost employment by increasing labor supply). If the wage credit increases real estate values, there may be positive indirect effects on employment, but these are likely to be small. For example, higher real estate values could increase property taxes and higher taxes might increase government employment. Higher real estate prices could mean higher incomes for owners of real estate, but this is unlikely to increase employment because it is often the case that owners do not reside in the District and in any case are unlikely to spend a significant amount of their gain in the District. Higher real estate prices could induce more building in the District and this would increase employment in the District, but because increases in property value are probably temporary — given the five-year life of the zone — any increase in construction-related employment seems unlikely. In the extreme case, if all of the value of the wage credit is reflected in higher property values and rents, the direct incentives for businesses to relocate to the District or to expand existing employment are entirely eliminated.

Labor market effects

There is a wide variety of effects that the wage credit can have on the labor market in and around the District. For expository purposes, this section divides the economic effects of the wage credit into two categories. First, there are the impacts of the wage credit on the *total level* of employment in the District and the surrounding area. Second, there are the impacts of the credit on the *composition* of employment in the District and the surrounding area.

IMPACT OF THE TOTAL LEVEL OF EMPLOYMENT IN THE D.C. AREA

In order for area employment to increase, there must be an increase in the total demand for labor and an increase in total supply of labor. There are basically two reasons for total labor demand to increase: (1) an increase in business activity and (2) a switch toward labor and away from other inputs.

Increase in labor demand (increasing D.C. area "exports"). Employment might increase if the lower after-tax labor costs due to the wage credit allowed District businesses to lower their prices and, in turn, these price reductions sparked increased demand for the employers' products. Because the relative effect of the wage credit is larger for employers who pay low wages, this type of response is more likely for a firm using low-skilled labor. It also is more likely for a labor-intensive firm where labor costs are a greater percentage of total costs. Finally, it also more likely in a highly competitive market where a small change in price is more likely to have a major impact in product demand. Thus, wage credits are most likely to increase employment in low-paying, labor-intensive industries operating in highly competitive markets.

To increase the *overall* level of employment in the D.C. area, it is important that these products are "exported" out of the region (i.e., they do not take away market share from other D.C. area businesses). Low-tech manufacturing and telephone marketing are types of businesses in which the wage credit has a lot of potential to increase overall area employment. These businesses are highly competitive. They pay relatively low wages. Their market is national, not local. And in the case of telemarketing, their business is labor-intensive.

But there also are many types of businesses where increases in regional employment are not likely. Retailers may pay low wages and be in a competitive market, but a retail business in the D.C. enterprise zone that is able to increase its product sales through lower prices made possible by the wage credit is primarily going to reduce the market share of other D.C. area retailers.

Increase in labor demand — substitution of labor for other inputs (capital, materials, imported services). Even without an increase in demand for employers' products, it is still possible for the wage credit to increase the demand for labor if businesses substitute labor for other production inputs. The wage credit has this potential because it reduces the price of labor relative to other inputs.

Much economic research has been devoted to measuring how much labor and capital may substitute for each other. Although some economists believe that labor and capital have a fair degree of substitutability, most economists do not. The majority view is that the proportion of capital and labor inputs remains fairly constant in the face of any changes in the relative costs of labor and capital — whether or not those changes are due to taxes. This is particularly true over shorter time horizons. Even if a change in the production mix makes sense, it usually takes time to recognize the need and then more time to implement that change. Because the D.C. enterprise zone has only a five-year life span, the ability to substitute capital for labor is particularly limited. Given all this, it does not seem likely that there will be any significant increase in employment because labor is being substituted for capital. To the extent there is any impact on the mix of capital and labor, it is more likely to occur in cases where the credit delays the adoption of labor-saving technologies.

Lower labor costs might cause a business to rethink other operational issues besides its capital intensity. For example, a District business may now be contracting with a foreign company to perform its data entry or its computer programming. A wage credit for local labor could cause the business to reconsider foreign outsourcing. But the limited time the credit is available becomes an issue. Because the wage credit is only available for five years, any decision to reduce outsourcing might have to be revisited in the near future.

Increase in labor supply: reduction in voluntary unemployment. Economists divide unemployment into two categories: voluntary and involuntary. A person is voluntarily unemployed when jobs are available but the employee is unwilling to work at the going wage rate. To noneconomists, the notion of voluntary unemployment often seems strange. This is because they think of the labor market as having a fixed supply of labor: people must work to live, and they try to get the highest-paying job that is available to them. In such a world there is no such thing as voluntary unemployment. This is, in fact, a fair description of primary earners of middle-class households. In general, the only time these workers are unemployed is during the transition between jobs.

But for some individuals, working is not a necessity. The amount of work they are willing to perform depends on prevailing wage rates. This is often the case for second (or third) earners in a household, senior citizens, and students. For these individuals, there is a thin line between working and not working. For example, a married woman considering re-entering the labor market after maternity leave may not find working economically viable given the high costs of daycare. A college student can take out more student loans instead of working. A senior citizen with pension income can simply reduce consumption rather than work. For unemployment among these types of individuals, it is not the lack of available jobs that is the problem. For employment to increase among these individuals, it is necessary for the wage credit to increase wages.

One type of voluntary unemployment deserves special mention. In high-poverty urban areas where crime is prevalent, employment in illegal activities is frequently an option to employment in the legitimate labor market. Many believe that low wages deter residents of high-crime areas from entering the labor market.[8] If the wage credit is successful in raising wages, it may not only increase employment but may also help reduce crime. Of course, the most the wage credit could even theoretically raise wages is by 20 percent — and by probably much less in reality. For employees earning the minimum wage, this is a little more than a dollar an hour wage increase.

Alternatively, the wage credit also could increase labor supply through an increase in immigration into the Washington metropolitan area. Such an increase in labor supply may improve the District business climate by increasing the availability of workers. It is important to recognize, however, that this may not improve the economic status of current residents. Also, any residents lured into the District by the positive effects of the wage credit could face unemployment when the wage credit expires at the end of 2002.

Offset market restrictions: the wage credit and the minimum wage. Economists use the term involuntary unemployment when individuals are willing to work at the going wage but simply cannot find a job. This occurs if there are laws that set a minimum wage above the wage rate which would prevail in the free market. Under current law, the federal minimum wage is $5.15 per hour ($10,712 annually for full-time employment). The District has a minimum wage of $6.15 per hour ($12,792 annually for full-time employment). For employers who pay the minimum wage to full-time employees working in the D.C. enterprise zone, the employer receives $2,558.40 of wage credit for each employee.

As noted above, the wage credit is particularly important for low-wage employment. For businesses that would like to employ more low-skilled individuals but are deterred by the minimum wage, the wage credit should be a significant incentive. For these employers, the wage credit is equivalent to a 20-percent reduction in the minimum wage (i.e., from $6.15 to $4.92 an hour).

No change in overall employment. This section has suggested many ways that the wage credit could influence area employment. But the large variety of possibilities should not be confused with a high probability that any of them will occur. It is possible, even with its $500 million price tag, that the wage credit could have no appreciable impact on overall employment in the District or in the surrounding areas. Except in the case where the minimum wage is the cause of unemployment, there has to be an increase in *both* the demand for labor *and* the supply of labor. If a 20 percent reduction in wage costs for low-wage workers does not induce firms to switch to more labor-intensive production or expand their market share by passing on lower cost *and* if the wage credit does not also increase immigration or reduce voluntary unemployment, then overall employment credit will not increase in the Washington metropolitan area.

If minimum wage laws are not a significant deterrent to employment (particularly in the current robust business climate), the potential for the wage credit to increase employment is further restricted. There is much debate among economists and politicians about the impact of the minimum wage on unemployment. It is clear that the minimum wage is much less significant in a strong economy where the demand for labor is high and market wages are rarely below minimum wage.

In addition, the credit's relatively short life span of five years has to be a serious deterrent to its ability to increase employment even temporarily. It may not be worth the cost and the effort to recruit new workers that may be uneconomical to retain at the end of 2002 when the credit expires. Obviously the temporary nature of the credit is an impediment to increasing permanent employment.

If there is no increase in overall employment, the wage credit's impacts are confined to shifting the composition of employment in the area's labor market. The following paragraphs discuss shifts in the composition of the labor force that might occur with or without an expansion of overall employment.

SHIFTS IN THE COMPOSITION OF WASHINGTON AREA EMPLOYMENT

Substitute District residents for nonresident employees. One possible response to the new wage credit by employers conducting business in the D.C. enterprise zone is to favor hiring (and encourage retention) of District residents over employees and potential employees who are not residents of the District. This seems likely if employers are indifferent to the residence of their employees.

Relocation of local operations into the D.C. enterprise zone. Another possible response to the wage credit by Washington area employers is the relocation of business facilities into the D.C. enterprise zone. This is much more likely where small changes in location do not significantly affect operations. For example, a garage that services cars and trucks and whose location is already close to the D.C. enterprise zone could relocate into the zone with little impact on its business.

Many businesses may wish to keep their front offices in prominent downtown locations, but they may be able to shift their "back room" operations (accounting, billing, keyboarding, telephone sales, administration, etc.) into the D.C. enterprise zone with little or no impact on their customers.

On the other hand, location is extremely important to retail outlets, bank branches, and personal service firms. It is often difficult for these businesses to change locations (although moves of one or two city blocks, e.g., across Wisconsin or Pennsylvania Avenues, are not bad even for these location-sensitive businesses).

Outsourcing and employee leasing by the District government. One of the largest employers in the District is the city government. The government, however, cannot directly benefit from the new wage credit because it does not pay any federal income taxes.[9] One possible response to this limitation would be for private-sector firms to perform government services now performed by District employees. This would make it possible for private firms to earn tax credits that would otherwise not be available. And it would be possible to share the economic benefit of these credits with the District government. There are at least two ways this could occur: first, through employee-leasing, in which the District government could arrange for a company to become the legal employers of its workers, and second, through outsourcing and privatizing services now performed by District government employees.

Outsourcing and employee leasing by nonprofit organizations. The District economy has a large nonprofit sector. Because nonprofit organizations pay no federal income taxes, they are not able to claim any tax credit for wages paid to their employees who work in the D.C. enterprise zone.[10] Just as in the case of the District government, nonprofit organizations with operations in the D.C. enterprise zone may be able to indirectly garner the benefits of the employment tax credit by entering into employee-leasing arrangements with outside firms or by contracting out services currently performed by in-house employees.

Shifting the composition of workforce to low-wage employees. The value of the employment credit per dollar of wages paid is three times greater for an employee with an annual salary of $15,000 than it is for an employee paid $45,000. As a result of the credit, businesses operating in the D.C. enterprise zone

Example

A large nonprofit organization located in the D.C. enterprise zone publishes several monthly newsletters and does extensive fundraising by mail. It currently employs a staff of 20 individuals full-time to perform these operations. The average salary of these employees is $20,000 and each individual earns more than $15,000. The total annual payroll of the staff is $400,000, and the total annual compensation costs (including taxes and benefits) amount to $475,000. Twelve of these individuals are District residents. Beginning in January 1998, the organization arranges for the entire staff to be hired by a firm in the business of employee leasing. The employees still work on the premises of the organization, they perform the same duties, they earn the same salaries, and they are still supervised on a day-to-day basis by the organization's managers. On its 1998 federal tax return, the leasing firm includes $36,000 of tax credits on the wages of the 12 District residents employed in the D.C. enterprise zone. For the services of the 20 employees, the leasing firm charges the nonprofit organization $457,000 annually. This is a savings of $18,000 to the nonprofit organization over its total costs without leasing. After paying employee salaries, payroll taxes, and benefits of $475,000, collecting $475,000 from the nonprofit organization, and claiming $36,000 of tax credits, the transaction has yielded a gross profit of $18,000 for the leasing firm.

have an incentive to replace high-skill employees with low-skill employees. For example, a nursing home would now have more incentive to replace nurses with nurses' aides.

Incentive to shift from full-time to part-time employees. Just as employers will have incentive to shift from high- to low-skill workers, employers also will have incentive to use more part-time employees. As noted above, a full-time employee earning the District minimum wage earns less than $13,000. As shown in Figure D-3, for these lowest-paid workers, there is no incentive for employers to shift from full-time to part-time employees. But for wage rates higher than the minimum wage, the incentive to move to part-time instead of full-time employment grows larger.

Incentive to shift from permanent to temporary employees. Just as the credit encourages part-time employment, the credit also encourages temporary employment of all but the lowest paid employees. Once an employee who is a District resident is paid $15,000 during a year, no additional wage credits can be earned in that year. From the standpoint of minimizing taxes, it is better to use a series of temporary employees rather than foster permanent employment. The tax incentive for high turnover is larger, the higher the salary of the employee. The only

Figure D-3

Greater Incentives for High-Wage Employees to Work Part Time

Hourly Wage Rate	Full-Time Annual Salary	Percentage of Full-Time Employment (Hours per Week) to Maximize Wage Credit
$6.15	$12,300	100% (40 hrs.)
7.50	15,000	100 (40 hrs.)
10.00	20,000	75 (30 hrs.)
12.50	25,000	60 (24 hrs.)
15.00	30,000	50 (20 hrs.)
20.00	40,000	38 (15 hrs.)
30.00	60,000	25 (10 hrs.)

requirement of the statute is that the employer employs the District resident for at least 90 days.

For example, a business operating in the D.C. enterprise zone has several computer programming projects it needs accomplished over the following year. If that firm hires a single programmer (who is a District resident) with an annual salary of $60,000, the business earns $3,000 of wage credits. Alternatively, if that firm hires three computer programmers (who are District residents) for four months each, and pays each $20,000, the business earns $9,000 of wage credits.

Incentive to shift to part-time employees from part-time independent contractors. As a result of the wage credit, businesses may want to reconsider their relationships with independent contractors. Wages paid to owners of a business (and their relatives) do not qualify for the wage credit. This includes the earnings of self-employed individuals. Therefore, if an individual who currently performs services as an independent contractor became an employee, the payments to that individual would become wages qualified for the credit (as long the individual were employed for at least 90 days). This reconfiguration from independent contractor to temporary employee or part-time employee can be particularly lucrative to District residents who currently have contracts with multiple firms in the D.C. enterprise zone. District residents can generate more than $3,000 per year of wage credits by working for multiple employers as long as they earn more than $15,000 and they work a least 90 days for each employer.

IMPACT ON TRAINING AND EDUCATION

Included in the definition of wages qualified for the credit are payments by the employer of an employee's undergraduate education expenses. And for employees age 18 or under, the definition of qualified wages includes any amounts paid or incurred by an employer for any youth training program that the employer operates in conjunction with local education officials. This could be an important incentive for temporary employees, for part-time employees, and for full-time employees being paid wages less than $15,000 annually. Unfortunately, these employees in practice are least likely to attract employers' investment in education and training — particularly out-of-pocket expenses.[11]

There is no marginal incentive once the amount of wages paid in any year exceeds $15,000. Therefore, the credit provides little incentive for training full-time employees earning more than the minimum wage. Furthermore, because the credit favors low-wage over high-wage jobs, businesses may deliberately keep their operations "low tech" to accommodate workers with the least skills.

On the other hand, the $15,000 annual limit may have an indirect effect on employee training, particularly with regard to "soft skills," i.e., good work habits. Because the credit only applies to the first $15,000 in wages, it encourages entry-level employment that by its nature elicits more on-the-job training by employers. For example, instead of hiring an experienced salesperson for $40,000 (and getting a $3,000 wage credit), a business could hire two inexperienced salespeople for $20,000 (and get $6,000 in wage credits). The amount of on-the-job experience and learning will be greater for the two younger recruits than it will be for a seasoned veteran.

CAPITAL INCENTIVES

Introduction

In addition to the wage credit, Congress provided businesses in the District three new incentives for investment (Figure D-5, page 108). The first is the availability of $20,000 of additional expensing for purchases of machinery and equipment by small businesses located in the D.C. enterprise zone. The second is the availability of up to $15 million of tax-exempt bond financing of business facilities inside the D.C. enterprise zone. The third is a zero-percent rate on the gain from the sale of a business formed after 1997, located in the D.C. enterprise zone (including Census tracts with 10 percent poverty), and owned by the investor for at least five years.

Before discussing the many important differences between these three capital incentives, it may be helpful as a point of reference to note how they are similar. In brief, for investments that qualify, each of the three capital incentives provide an exemption from federal income tax, or the equivalent of a tax exemption, on income from that investment:

Expensing. Accelerated tax deductions in effect allow taxpayers to pay taxes late but without any interest charges for those late payments. The value of this interest-free loan is approximately equal in value to a tax exemption for the underlying investment.[12] The effective tax rate on the investment is approximately equal to zero.

Tax-exempt bonds. Interest income paid on bonds used to finance qualified investments is exempt from federal income tax. The effective tax rate on the debt-financed portion of the underlying investment is zero.

Zero-percent capital gains. Capital gains from the sale of qualified D.C. enterprise zone investments are exempt from tax. If the income from business capital can be retained by its owners until it is sold (that is, not be paid out in interest or dividends), the effective tax rate on the underlying investment is zero.

The equivalency in the value of these incentives holds pretty well when the underlying investments earn a "normal" or average rate of return. As discussed below, when investment returns are uncertain or not "average," the equivalency breaks down. But as a first approximation, it is useful to recognize that these three tax incentives basically exempt income from qualified investments from tax. So per dollar of qualified investment, the incentive effects are similar. The major differences lie in the dollar amounts and types of investment that qualify.

Additional expensing

There are many reasons to expect that the provision for additional expensing will not have any significant impact on capital investment in the District. First of all, for the businesses that qualify, the value of the incentive is small. On a present value basis, if a business utilizes the full $20,000 of additional expensing available, the value is in the neighborhood of $500–$2,000 per year. In general, the value of the expensing is larger for firms with higher tax rates, with higher discount rates, and that make longer-lived investments. The only circumstances where the economic value of the credit conceivably could exceed $2,000 is where a business was extremely strapped for cash and was willing to pay usurious rates for what in effect is a $20,000 term loan from the federal government.

The second reason why expensing is likely to have limited impact on investment in the District is that a firm must meet several other requirements in order to qualify.

First, like all the other income tax incentives, a business must be subject to tax for it to be of any value. Accordingly, governments and nonprofit organizations located in the District generally do not get any benefit from the availability of expensing. But in addition, businesses that do not generate any taxable income because they are starting up or because of a business downturn do not get any immediate benefit.[13]

Furthermore, expensing is only available to enterprise zone businesses operating in the District. In order to be an enterprise zone business, an entity must conduct most of its business inside Census tracts in the District with a poverty rate of more than 20 percent.

Also, additional expensing available in enterprise zones only provides benefits to businesses that are not too small and not too large. As discussed in more detail in the Afterword of this chapter, expensing is already available inside and outside of empowerment zones for the first $18,000 of investment in qualified equipment. (This amount will be $18,500 in 1998 and gradually increase to $25,000 by the year 2003.) Because firms with less than $18,000 of qualified investment are already fully eligible for expensing, they get no additional benefit from the 1997 legislation. Expensing is phased out for larger firms with more than $200,000 of qualified investment. The additional benefits of empowerment zone expensing start to phase out at investment levels exceeding $200,000. In summary, only mid-sized firms get any additional benefit from the new expensing provisions for the District. Businesses with qualified investment in any year below $18,500 or above $288,000 get no benefit at all.

The final reason to expect that additional expensing will have little positive impact on investment in the District is that the incentive is designed in such a way that it does not play a major role in investment decisions. For example, a firm that currently invests $50,000 each year in equipment will qualify for additional expensing, but expensing is not likely to have any impact on marginal investment decisions. For example, suppose this firm is trying to determine whether it should increase its investment from $50,00 to $150,000.[14] Because increasing investment does not increase the amount that can be expensed, the credit provides no marginal incentive. The business earns the credit, but the credit has not affected its decision to invest.

In summary, the availability of additional expensing in the D.C. enterprise zone provides limited tax benefits. It is unlikely to have any significant impact on business investment in the District. Nevertheless, because the benefit has an annual value of approximately $1,000 in each of the next five years, a large number of business owners will qualify.

The only aspect of expensing that is more generous than the other two new investment incentives for the District is that there are no restrictions on how the investment is financed. Investment qualified for additional expensing may use either debt or equity. In contrast, tax-exempt bond financing can only benefit investment projects with debt-financed projects while the zero-percent capital gains rate is only available to equity-financed projects.

Tax-exempt bonds

The second new capital incentive available in the District is the expanded availability of tax-exempt financing for business property in areas of the District with poverty rates of 20 percent or more. These new bonds may be issued during the five-year

Example: Distribution center

A business decides to build a new warehouse and distribution center in the D.C. enterprise zone at a cost of $10 million. The business decides to use 25 percent equity and 75 percent debt to finance the project. The District government allocates some of its private activity volume cap to this business so it may issue $7.5 million in bonds with a 15-year maturity. With the tax exemption, the business is able to obtain financing with a rate of interest of 6.5 percent instead of the 9 percent rate that otherwise would have been available. This saves the business $187,500 per year for the entire 15-year life of the loan.

period beginning after December 31, 1997. No business in the District may have more than $15 million of these bonds outstanding at any one time.[15]

A qualified zone facility is any tangible property (including buildings and their structural components) and any land which is functionally related and subordinate to such property. In order to be eligible, the property must be used in the active conduct of an enterprise zone business and this business must be the principal user of the property. (Bond proceeds may not used for real estate speculation.) For a business that can obtain this financing, the benefits can be substantial.

It is not necessary for enterprise zone facility property to be owned by the D.C. enterprise zone business to qualify for tax-exempt financing. The only requirement is that the property is used by enterprise zone businesses. Therefore, the property can be leased to enterprise zone businesses and still qualify for tax-exempt financing.

Unlike business stock eligible for the zero-percent capital gains rate (discussed below), tax-exempt financing for enterprise zone businesses cannot be used to finance business start-up costs, inventories, or the development of intangibles (e.g., through research, through advertising, or through training of employees). This excludes from eligibility many of the capital needs of the service sector in the District.

From a Districtwide perspective, the authority to issue enterprise zone facility bonds may be of limited benefit. Under current law, the District may issue no more than $150 million in private activity bonds annually. In addition to enterprise zone facility bonds, private activity bonds include:

1. exempt facility bonds, used to finance airports, docks and wharves, mass transportation, water works, sewage facilities, solid waste disposal facilities, residential rental projects, electric and gas facilities, heating and cooling facilities, hazardous waste facilities, and high-speed intercity rail facilities;
2. mortgage revenue bonds;
3. veteran's mortgage bonds;

4. small issue bonds;
5. student loan bonds;
6. redevelopment bonds; and
7. tax-exempt organization bonds (501(c)(3) bonds).

All these types of bonds can help promote economic development in the District. Because the volume cap is binding, if fewer of these bonds are issued when enterprise facility bonds are issued, the overall positive impact for the District is limited.[16] In general, however, the District does not use all of its authority to issue tax-exempt bonds, so it is likely more private activity bonds will be issued in the District as a result of the new federal law.

From a business's point of view, tax-exempt financing is an excellent incentive if qualifications can be met and if the authority exists under the private activity volume cap. Unlike the capital gains incentive (discussed below), existing businesses are eligible. However, unlike expensing or tax-free capital gains, there is a lot more involved than filing the appropriate tax returns at the end of the year. The business must undertake an extensive application process with no guarantee of success.

Tax-free capital gains

OVERVIEW

Like enterprise zone facility bonds, the zero-percent rate on capital gains is a substantial incentive for investment in the D.C. enterprise zone. The good news for investors is that unlike tax-exempt bond financing, it does not require the approval of a government body and there are no dollar limitations. The bad news is that existing businesses are not eligible.

UNIQUE FEATURES OF THE CAPITAL GAINS INCENTIVE

Incentive for high-return, high-risk investments. As noted above, if an investment has an average rate of return, the zero-percent capital gains rate is like expensing or tax-exempt financing in that income from the investment is totally tax-free (or equivalent to being totally tax-free). When an investment has an above-average rate of return, however, an exemption from capital gains tax is superior to the other two investment incentives available in the D.C. enterprise zone. If an investment has above-average profitability, only the normal return on the asset is tax-free when the cost of that investment is expensed. Similarly, with tax-exempt bonds, the investment is tax-free only to the extent of the stated rate of return on the bonds. In contrast, all capital gain of qualified assets is exempt from tax irrespective of the rate of return. Therefore, the greater the profitability of the investment, the greater the value of the tax-free capital gains relative to the other two capital incentives available in the D.C. enterprise zone.

No limitation on size of investment. In addition to lack of limits on the rate of return exempt from income, there are no dollar limitations on the size of the investment. An investor could invest a billion dollars or more in a business in the D.C. enterprise zone and be exempt from all capital gains tax on that investment.

Expanded definition of poverty areas. For a business's stock to qualify for the zero-percent capital gains rate, it must generate at least 80 percent of its gross receipts from business conducted in District Census tracts with poverty rates greater than 10 percent. This rule is both less restrictive and more restrictive than the rules that apply to the two other new investment incentives. It is more restrictive because the other incentives generally only require that 50 percent of gross receipts be generated in the qualifying area. But it is less restrictive because the area that qualifies is much larger and generally more attractive than Census tracts with 20 percent poverty. On net, because the geographic area is significantly expanded in terms of both size and desirability of location, the capital gains incentive is probably the least geographically restrictive of the three capital incentives. For example, investors that are considering constructing a new hotel in the District are probably not significantly affected by the increase in the gross receipts test from 50 percent to 80 percent. But the expansion of the eligible geographic area from Census tracts with more than 20 percent poverty to Census tracts with more than 10 percent poverty probably more than doubles the list of potential sites.

Special attraction for intangible investment. In most respects, the definition of qualified investment is broader for enterprise zone capital gains than is expensing or exempt-bond financing. Expensing is only available for investment in new equipment. Tax-exempt financing is only available for equipment, new buildings, and renovated buildings, and for land functionally related to these buildings. Tax-free capital gain is available upon the sale of all of these assets but also upon the sale of ownership interests in certain corporations and partnerships. (In addition, the definition of substantially renovated property is much less restrictive.) If a business operates in the zone as a corporation or partnership, that corporation and partnership has wide discretion on how to invest its funds and still qualify for the zero-percent capital gains rate. It can invest in both old and new buildings as well as equipment and land as long as these investments are related to the active conduct of a trade or business. Moreover, the corporation or partnership also may invest in the purchase and development of intangible assets as well (as long as they are related to the trade or business). For example, capital gains from investment in the form of expenditures on salaries for research and development (e.g., to develop a patent) or of advertising expenditures (e.g., to get recognition of brand name) qualify. Any return on these investments realized on the sale of stock or partnership interest would be exempt from tax.

Incentive for retained earnings. If earnings of a corporation are distributed, tax must be paid on the full amount of the dividend at the shareholder's tax rate. For upper-income taxpayers, these rates are 28 percent, 36 percent, and 39.6 percent. In the new D.C. enterprise zone, earnings realized upon the gain from sale of stock from a qualified business will pay a zero-percent rate. This creates a large incentive to retain earnings. A business that distributes all of its income may realize little or no benefit from the lower capital gains rate.

Incentive for businesses that can develop brand names and new technology. Firms that generate most of their value from the services of a few key individuals who are also owners of the firm are not good candidates for the new District zero-percent capital gains rate. This is because such a service firm has little to sell when its owners leave. (In addition, because these firms generally must provide current income for their owner-entrepreneurs, much of the income of the firm must be paid out in wages and dividends. This can significantly diminish the opportunity for capital gain income brought about by reinvestment of profits into the business.) Firms that can develop intangibles — such as brand names, customer lists, patents, customized software, or even a loyal and well-trained workforce (known as a "workforce in place") have assets that can be sold at the end of the owners' tenure that can generate tax-free capital gain.

Risks of disqualification

The new law requires that 80 percent of the gross receipts must be derived in the expanded D.C. enterprise zone redefined to include all Census tracts with at least 10 percent poverty. Also, a substantial portion of the assets of the business and a substantial portion of the services must be performed in Census tracts in the District with at least a 10 percent poverty rate. As discussed previously, it is unclear exactly what is meant by a "substantial portion." This uncertainty in and of itself poses potential risk to investors whose companies operate inside and outside the zone.

> ***Example: Demand-side risk***
>
> A D.C. enterprise zone business develops a new type of solar cell that works particularly well in cold climates. Because there are lots of solar cells that work well in warm climates, this new solar cell is only economically viable in regions considerably north of the District. This company may need to set up substantial operations outside the District to stay in business. If this occurs within five years after the stock is initially offered, the stock of this business may completely lose its eligibility for a zero-percent capital gains rate.

Example: Supply-side risk

A data management firm qualifies as a business whose stock (issued in 1998) is eligible for the D.C. enterprise zone zero-percent capital gains rate. Because economic development efforts in the District (and throughout the surrounding region) have been successful, it has become increasingly difficult to hire experienced computer programmers. Suppose also that an opportunity arises in 2001 for the District firm to acquire another business in Prince George's County whose workforce in place can relieve the District firm's shortage of computer programmers. This strategic acquisition solution may disqualify its stock from eligibility for the zero-percent capital gains rate.

But even in the case of a business for which there is no question as to its *current* qualification as a business whose stock is eligible for the rate, there may be tremendous uncertainties as to qualification in the *future*. If a new company is successful, the requirement that its business be conducted largely within areas of the District with poverty rates of 10 percent or more may become an economic straitjacket.

Any individual contemplating the purchase of stock in a District business intending to realize tax-free capital gains has to take into account tax risks like these. Because the stock must be held for at least five years, it is extremely difficult for investors to forecast if it will make sense for the business to stay in the qualified areas of the District for the entire holding period. If investors are not majority shareholders, they may not even have control over business decisions that could eliminate eligibility for the zero-percent capital gains rate.

If after five years the stock becomes disqualified, the gain accumulated through the date of disqualification remains tax-free (and any subsequent gain is subject to the normal capital gains rate — generally, 20 percent). This means that in practice any particularly successful District business that grows out of the zone only has a partial exemption from capital gains — and the greater its growth, the smaller the tax benefit.

Conclusion: types of business likely to take advantage of the zero rate

The statutory rules restrict the type of assets eligible for the new zero-percent rate on District capital gains. Gain from the sale of land does not qualify unless the land is used in the conduct of an active trade or business. Gain from the sale of businesses existing before the existence of the D.C. enterprise zone does not qualify. But economics as well as legal statutes can effectively restrict the types of investment that are likely to benefit from the capital gains rate. For example, if a sole proprietor (who is not a dealer in used equipment) invests in equipment and uses it in his business for more than five years, he may be eligible under the law for a zero rate on a portion of capital gain resulting from that sale. But this is a trivial benefit because no business has much prospect of reselling their own obsolescent equipment with any significant capital gain.

There are many other circumstances where the availability of a zero-percent capital gains rate is not particularly helpful even for businesses that qualify. For example, suppose an individual establishes a retail food store in a Census tract in the District which has a poverty rate of 10 percent or more. Assuming the store is not disqualified for selling alcohol for consumption off-premises, it may be eligible for the zero-percent capital gains rate. Typically, most income generated by "mom-and-pop" business must be distributed to the owners (in the form of either wages or dividends) to meet the owner's current living expenses. This income is fully taxable at the owner's tax rate. If earnings are not reinvested in the business, the opportunities for growth (and large capital gains) are diminished. If the owner wishes to sell before the end of the five-year holding period, there is no preferential capital gain rate. If the owner intends to retain the business until death, the zero-percent capital gains rate provides no additional benefit, because under current law ownership can be transferred to an heir without any income tax on gains accruing during the owner's lifetime. (With or without a zero-percent capital gains rate, this business still may be subject to estate tax under current law or the new law.)

Another type of business where the zero-percent capital gains rate is not particularly useful is a small service business where the skills, experience, and business contacts of the owner are the firm's primary asset (e.g., a small law or consulting firm). When the owner wishes to end this line of work (whether for retirement or to join with another firm), there is little left to sell that can generate a capital gain.

In addition to small firms, large firms may not get much benefit from a zero-percent rate either. For example, if a group of venture capitalists were to invest in an entirely new technology in the hope of establishing the next Microsoft, the D.C. enterprise zone would not be an attractive alternative because the likelihood of obtaining 80 percent of gross receipts from its District operations may be practically impossible. Violation of this 80 percent rule during the first five years eliminates the availability of the zero-percent rate on any gain. Even after five years, violation of the rule may still severely limit the portion of any gain eligible for the preferential rate.

The type of businesses that are likely to get the most out of the zero-percent capital gains rate are new business start-ups that are neither too large nor too small. Investors in these businesses should not be risk-averse, should not require current dividends, and should be able to hold their stock for more than five years. This profile would suggest that venture capital funds or wealthy individuals are the types of investors most likely to benefit from the District's zero-percent capital gains rate.

Also, the business should be one that can grow without being hampered by relatively tight geographic constraints.

If a business by its nature provides services in a number of locations, there may be difficulty generating 80 percent of gross receipts entirely inside the 10-percent poverty areas of the District. But if the services can be provided readily at single locations or in small geographic areas (e.g., a hotel, a restaurant, guided tour business) the ability to retain eligibility for the zero-percent rate is simpler. In the case of manufacturing, a business is more likely to be eligible for the zero-percent rate if production is in the D.C. enterprise zone and the firm can then readily "export" outside of the zone.

The first-time homebuyer credit

Taxpayers who have not recently owned a home in the District may be eligible for a tax credit of up to $5,000 of the purchase price of a principal residence in the District. Households with high incomes receive a reduced credit or no credit at all. For single individuals, the credit is reduced by 25 cents for each dollar that adjusted gross income exceeds $70,000. Therefore, no credit is available for single individuals with incomes in excess of $90,000. For married couples, the credit is reduced by 25 cents for each dollar that adjusted gross income exceeds $110,000. Therefore, no credit is available for married couples with incomes in excess of $130,000. The credit is available for home purchases after August 5, 1997, and before January 1, 2001. Any credit not used because the taxpayer has insufficient tax liability in the year of purchase may carry forward excess credit and use it to reduce income tax in any following year.

The credit is not refundable and it is only creditable against federal income tax. If an individual or family does not have sufficient income to owe any federal income tax, the availability of the homebuyer credit does not provide any benefit. Under current law, a family of four with approximately $25,000 of adjusted gross income does not have any income tax liability. At the other end of the income scale, the credit does not provide any benefit to high-income households above the phase-out ranges. Thus, the first-time homebuyer credit is a tax cut targeted to the middle class.

Even among middle-class taxpayers, however, the benefits of the credit may be less generous than the $5,000 may at first appear. For lower middle-class families — particularly those eligible for the new $500 per-child tax credit — relatively low tax liability makes the credit hard to absorb. For example, a family of four earning $40,000 would need at least three years to generate sufficient federal income tax liability to fully use the credit.

Because the value of the homebuyer credit does not vary with the size of the home purchased, it provides a relatively larger incentive for homes that are less expensive. For a $50,000 one-room condominium, a $5,000 homebuyer credit is

10 percent of the purchase price. For a modest $200,000 home in a middle-class neighborhood, a $5,000 homebuyer credit is only 2.5 percent of the purchase price. For this reason, and for reasons mentioned above concerning income levels of homebuyers, the credit will probably have the most impact on homes typically purchased by lower middle-class homebuyers.

If the supply of middle-income housing is fixed, there is every reason to expect a rise in the property value of middle-class homes by an amount equal to some significant fraction of $5,000. For this to occur, there would have to be a rise in demand. If renters in large numbers leave their apartments for owner-occupied housing, and there is no conversion of rental units to owner-occupied units, housing prices will increase while rents decline. If there is an influx of population into the District as a result of the homebuyer credit, it is likely that both housing prices and rents will increase. In any case, however, it seems unlikely than increases in housing prices or rents will be enough to significantly affect prices. The most that a $100,000 unit could increase in price would be 5 percent — and because not all buyers are eligible, because those that are may get less than $5,000 in value from the credit, and because supply is probably not fixed — the increase in the price would probably be significantly less. Similarly, an apartment that rents for $800 dollar a month is not likely to have a rent increase of more than $40 as a result of the credit. It would probably be significantly less. And as noted, it is conceivable that rents could even decline as a result of the homebuyer credit.

There are several reasons to expect the credit to have minimal impact on the market for expensive homes. First, as a percentage of the purchase price, a $5,000 home credit is smaller for these higher priced homes. For a $400,000 home, a $5,000 homebuyer credit is only 1.2 percent of the purchase price. Moreover, most purchasers of these large homes also have large incomes and would not qualify in any case. Well-off retirees might have incomes low enough to qualify, but these individuals generally do not need or want large homes. (They are more likely to use the credit for high-priced condominiums.) It also is important to note that current District homeowners who wish to move into larger and more expensive homes do not qualify for the credit because they are not first-time buyers.

The first-time homebuyer credit is an incentive that may attract new homeowners into the District. It is worth noting, however, that the first-time homebuyer credit provides no incentive for retaining current District homeowners in the District. Also, there may be some potential for the homebuyer credit to encourage gentrification. The credit does not provide any incentive for renters or for low-income homeowners without taxable income to remain in their neighborhoods. The credit does, however, provide a lot of incentive for middle-income families to purchase inexpensive housing.

Expensing of environmental clean-up costs (brownfields)

Under current law, there is considerable controversy as to whether the expenses that businesses incur to clean up contaminated sites may be deducted against federal income tax. The reason for not allowing the deductions is that clean-up expenses are permanent improvements to land. Improving land is equivalent to purchasing land, and the purchase of land does not in and of itself justify any sort of tax deduction. Moreover, because land generally does not decline in value in any predictable way, there is no justification for allowing deductions for depreciation.

There is an alternative view, however. Current deductions for environmental clean-up expenses may be justified if, for example, a site became contaminated after it was purchased by its current owner. The environmental clean-up expenses are more like maintenance expenditures than capital improvements: The owner is incurring them to maintain the value of property. In this case, deductions might be justified even though they are clearly capital in nature because the owner never realized losses on the decline in property value that resulted from the contamination.

A 1994 IRS ruling (Revenue Ruling 94-38) does allow — under certain conditions — current deduction of environmental clean-up expenses for businesses whose property was contaminated while the business owned the property. As a result of this ruling, the major benefit of the new law is provided to remediation expenses incurred by businesses that acquired the property in its contaminated state (i.e., the business did not contaminate the site itself). In this case, for a large corporation paying the 35 percent corporate tax rate, the availability of expensing in the zone can reduce the after-tax cost by 35 cents on the dollar. As is always the case for tax incentives provided in the form of deductions, the incentive effect will be less for businesses that have lower tax rates or that do not have current tax liability.

There are no dollar limitations on the amount of property that any one business may expense. So, for example, if a large corporation with lots of tax liability spends $50 million to clean up a hazardous waste site in the D.C. enterprise zone, that corporation's taxes will be reduced by $17.5 million in the current year. Under the right circumstances, the availability of expensing can provide a significant incentive for private businesses to clean up their contaminated sites in the D.C. enterprise zone.

Because this tax incentive is not available uniformly throughout the country, but only in certain targeted areas (such as the D.C. enterprise zone), large corporations with numerous contaminated sites may give priority to sites in the D.C. enterprise zone and other designated areas. In addition, the pace of environmental clean-ups in the District may be accelerated because expensing for environmental clean-up costs in the D.C. enterprise zone will expire at the end of the year 2000.

Work opportunity tax credit for youths residing in the D.C. enterprise zone

The *Taxpayer Relief Act of 1997* modified the structure of the work opportunity tax credit (WOTC) and extended it through the first half of 1998. Under the new credit structure, the credit rate is 25 percent for less than 400 hours of employment and 40 percent for employment of 400 or more hours.

The WOTC is only available for employees who are members of certain targeted groups. Among the targeted groups eligible for the credit are high-risk youths and qualified summer youth employees. A high-risk youth is an individual certified as being at least 18 but not yet 25 years old on the hiring date and as having a principal place of abode within an empowerment zone or enterprise community. Qualified summer youth employees are individuals who:

1. perform services during any 90-day period between May 1 and September 15;
2. are certified by the designated local agency as being 16 or 17 years of age on the hiring date;
3. have not been an employee of that employer before; and
4. are certified by the designated local agency as having a principal place of abode within an empowerment zone or enterprise community. Because the D.C. enterprise zone also is an empowerment zone, qualified summer youth employees and high-risk youth employees residing in the D.C. enterprise zone qualify for the WOTC through the first half of 1998 when the credit expired.

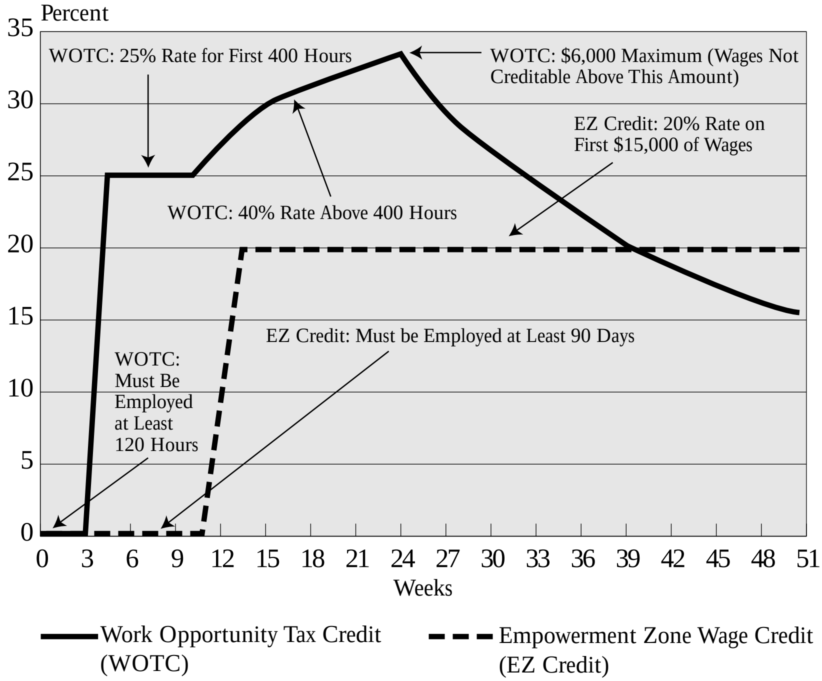
There are several aspects of the WOTC worth noting. First of all, if an employee is designated both high-risk and summer youth, an employer of part-time employees will generally want to claim the WOTC rather than the empowerment zone wage credit. For wages paid to full-time employees, the empowerment zone wage credit is generally more favorable. This is illustrated in Figure D-4.

Secondly, as long as the high-risk youth resides in the D.C. enterprise zone, the employer of that youth is eligible for the credit irrespective of where the services are performed. The service may be performed anywhere inside or outside the District.

Finally, George Washington University, Howard University, and Georgetown University — and the areas immediately surrounding them — are all part of the D.C. enterprise zone. Ironically, students at these schools qualify as "high-risk youth" whose wages are eligible for the work opportunity tax credit. As a result, employers will have a large incentive to hire these students part-time or during the summer. A student who works for $6.50 per hour for 23 weeks full-time or for 50 weeks half-time generates approximately $2,000 worth of tax credits. This is the same incentive available to 18–24-year-old youths in impoverished areas of south-

Figure D-4

Work Opportunity Tax Credit as Percentage of Wages for Youth Working Full Time at $6.50 per Hour



east D.C. This incentive is not available to many poor youths residing in the District but not inside the D.C. enterprise zone.

Making the most of the new tax incentives

It is too soon to tell if the new federal tax incentives for the District will be able to substantially improve the District's economy. There is no doubt, however, that these incentives — estimated to cost the federal government $1.2 billion over 10 years — have potential for some positive impact on the District. Moreover, their potential could be enhanced by complementary actions by the District government, the federal government, business organizations, and community groups. Whether or not these incentives are considered good policy — and regardless of whether they could be improved — it is up to the District to make the most of the unique opportunity that Congress has put at its doorstep. This concluding section explores some possible next steps for the District.

Marketing the new incentives

The new federal tax incentives will be most beneficial to the District economy if current and potential District businesses and residents are aware of them. Furthermore, the District will get maximum benefits if awareness is raised as soon as possible.

One place to begin marketing efforts is with businesses and individuals already in the District. For example, it would be a shame if middle-income District residents that do not own their own homes are moving out of the District, unaware that the $5,000 first-time homebuyer credit has been in effect since August 5, 1997. It is just as important to maintain awareness of the incentive as it is to raise awareness as the incentives come into effect, because it may take months or years for businesses and residents to respond to tax incentives.

Besides motivating current District businesses to increase employment and current residents to buy more homes, another source of growth for the District is attracting newcomers. This probably requires an entirely different marketing effort than that needed to raise awareness of incentives among current District businesses and residents.

The importance of moving quickly on marketing efforts is heightened by the relatively short lifespan of these incentives. For example, if it takes two years of study and planning to relocate a business into the District, and this process began on January 1, 1998, a business would only get wage credits for three years.

Businesses and individuals also must learn the intricacies of the new provisions. These tax incentives are complex, and in many cases details are exceedingly important in determining whether a taxpayer qualifies. In addition, a detailed knowledge of the D.C. enterprise zone is necessary. Detailed maps of the District indicating the borders of Census tracts and the level of poverty inside those Census tracts are a prerequisite for understanding the scope of these incentives. Making this information available at a reasonable cost will be particularly important to individual taxpayers and small businesses that may not be able to afford expert tax advisors.

The role of federal agencies

The Department of Housing and Urban Development (HUD) has been a major promoter of existing urban empowerment zones and has served as an important clearinghouse for information about the zones. In addition to HUD, other federal agencies help urban empowerment zones. For example, the Census Bureau provides detailed maps of empowerment zones and enterprise communities. Also, the Small Business

Figure D-5

Businesses and Property Eligible for Major D.C. Tax Incentives

Tax Incentive	Type of Property	Types of Businesses
Work Opportunity Tax Credit	n.a.	All businesses inside and outside the District
Expensing Environmental Remediation Costs	Qualified contaminated sites inside the D.C. enterprise zone	All businesses with at least some operations in the D.C. enterprise zone
20% Employer Wage Credit	n.a.	All businesses with at least some operations (except golf courses, massage parlors, etc.) in the D.C. enterprise zone
$20,000 of Additional Expensing	Enterprise zone property — mostly machinery and equipment	Enterprise zone business — narrowest definition, i.e., most business in areas with 20% poverty
Exempt Facility Bond Financing	Exempt facility property — same as above, but also new and substantially renovated structures and adjacent property	Enterprise zone business — establishments may be treated as separately incorporated
0% Capital Gains	Enterprise zone business property — same as above, except locations may have 10% poverty rates but enterprise zone business must meet an 80% gross receipts test	Enterprise zone business — using more restrictive 80% within-zone gross receipts test and less restrictive 10% poverty rate

Administration (SBA) has established "One Stop Capital Shops" in empowerment zones to bring together at one location the SBA's business development and capital resources along with other federal, state, local, and private sector resources.

It is unclear what degree of support HUD and other federal agencies will provide to fostering growth in the new D.C. enterprise zone. There does not seem to be anything to preclude HUD from assuming a major role as facilitator, promoter, and technical advisor. Given HUD's experience with empowerment zones and enterprise communities, it could be a valuable resource for the District.

Treasury regulations

Details matter, but many of the details of the new tax incentives for the District remain unsettled. The District's greatest challenges with respect to Treasury regulations are the new provisions that are unique to the District: the first-time homebuyer credit and the zero-percent capital gains rate. There are two reasons the District needs to be especially vigilant about these regulations. First of all, because these provisions only apply to the District, the resource-strapped IRS might be tempted to give consideration of these rules somewhat lower priority than it might give to issues regarding all empowerment zones. Secondly, because these are entirely new provisions, there is greater uncertainty about how these rules will operate.

The operation of the rules regarding the zero-percent capital gains rate is particularly uncertain for several reasons. First of all, the issues are complex. Second, a taxpayer investing in January 1998 will not be able to "cash in" his gains until January 2002 at the earliest. On the numerous issues where interpretation of the law is not clear, a taxpayer runs considerable risk undertaking any investment without the guidance of Treasury regulations.

The District may wish to consider requesting that the IRS set up a procedure — similar to the "advance pricing agreements" used to resolve international transfer pricing issues — where an investor in a new District business may be able to meet with the IRS and explain the plans for that investment. The IRS then could give some preliminary assurances to the investor that — as long as certain conditions are met — the IRS would not challenge the investor's use of a zero-percent capital gains rate when that investment is sold.

Further congressional action

Congress could be persuaded to amend the D.C. enterprise zone statutes in a manner that is favorable to the District, particularly if these changes are done in a revenue-neutral manner. For example, if it is discovered that tax-exempt financing is a much more attractive development tool than expensing, District officials might propose a trade where expensing is reduced and tax-exempt financing is increased in such a manner that does not increase the overall cost of enterprise zone tax breaks.

Of course the better outcome for the District would be for Congress to consider expanding some zone benefits without reducing any others. A list of possibilities includes:

- a more effective tax incentive for employee training
- making the homebuyer credit refundable so that it is useful to low-income families
- a homebuyer credit for current D.C. homeowners who "buy up" into larger homes
- allowing tax-exempt enterprise zone facility bonds to be issued outside the current volume cap
- making employers who are nonprofit organizations eligible for the wage credit by allowing them to use the employment credit to reduce their payroll taxes

But *probably the most important expansion of the current incentives for the District would be an extension of the life of the zone beyond its current five years.* Other empowerment zones generally have a 10-year life. Business simply may be unwilling or unable to respond to tax incentives that provide benefits over the relatively short horizon for the D.C. enterprise zone.

If Congress decides to provide such an extension, the District would benefit more if it is applied as soon as possible. Again, in order to get the most economic benefit from the incentives, it is important that businesses and individuals can have certainty over long horizons.

Reallocating District resources and modifying district policies

In addition to tax reductions, better public education, less crime, infrastructure improvements, and less regulation are all ways to help improve the attractiveness of the District to residents and businesses. This chapter has not discussed an overall economic development strategy for the District.

The District may wish to consider its own set of local tax incentives to complement the new federal tax benefits. As much as possible, the District should think about piggybacking on federal rules. For example, instead of offering an investment tax credit (an entirely new incentive), the District could offer a 5 percent wage credit that has exactly the same qualifications as federal rules.

The District also might want to fine-tune federal tax incentives by overlaying local tax incentives that benefit areas of the D.C. enterprise zones that are more in need of economic development than others, for example, Georgetown vs. Anacostia.

Finally, there may be nontax policies that may particularly complement the new federal tax incentives. For example, in order to be eligible for the wage credit an employee must be a District resident. The District might be able to establish an employment service that informs businesses in the D.C. enterprise zone of available workers who are eligible for the wage credit. Another possibility is to establish industrial parks or business incubators in the D.C. enterprise zone that cater to businesses concerned about security, infrastructure, and the availability of business services.

Conclusion: From a "capital city" to a "capitalist city"?

This chapter includes a lot of technical legal and economic analysis necessary to begin understanding how the new District tax incentives can affect the local economy. But as always, it is important not to allow details to obscure the big picture. It is true that the new tax incentives put dollars in the pockets of residents and businesses who decide to participate in the District economy. But it is possible that the most important effect may not be the dollars spent but the signal sent to residents and businesses. The new tax incentives can be used not only as a financial incentive but as a focal point of promotion for all the benefits of investing in the District economy.[17] It is no secret that many companies consider the District's business climate unfavorable. The new federal tax incentives offer a unique opportunity for the District to shed this reputation.

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Endnotes

[1] This estimate does not include the tax benefits of allowing immediate write-off of environmental remediation expenses (the so-called "brownfields" initiative) or the temporary extension of the work opportunity tax credit. These benefits are available in many areas of the United States in addition to the District, and no separate estimates for this provision's impact on the District are available.

[2] Census tracts are small, relatively permanent statistical subdivisions of a county. Census tracts are delineated for all metropolitan areas and other densely populated counties. Census tracts usually have 2,500–8,000 people and when first delineated are designed to be homogeneous with respect to population characteristics, economic status, and living conditions. The spatial size of Census tracts varies widely depending on population density. Census tract boundaries are delineated with the intention of being maintained over a long time so that statistical comparisons can be made from Census to Census. However, physical changes in street patterns caused by highway construction, new development, etc., may require occasional revisions; Census tracts occasionally are split due to large population growth, or combined as a result of substantial population decline. The District is covered entirely by Census tracts, which do not cross the District's borders.

[3] In addition, the wages of a resident of any part of the District can generate employer tax credits for their employers if the resident performs most of his or her service in the poorest parts of the District.
[4] The poverty rate of an area is the number of area residents living in households with incomes below the poverty level divided by the total number of area residents. Census data for 1990 indicate that of 570,826 residents of the District, 96,278 were living in poverty. Thus, the District had a poverty rate of 17.2 percent in 1990.
[5] As discussed in the previous chapter, employers receiving the wage credit must reduce their deductions against federal income tax by the amount of the credit. So, if a corporation is paying a marginal rate of corporate income tax of 35 percent, the net reduction in tax from the credit is not $3,000 but $1,950 (that is $3,000 less 35 percent of $3,000). In pre-tax dollars, the value of the credit is $3,000 but in after-tax dollars the value of the credit is $1,950. This report describes the credit as a "$3,000 credit" because day-to-day commerce figures (e.g., salaries, profits) are usually discussed in terms of pre-tax values.
[6] In other words, the total rental cost per employee is $4,625. The $3,000 tax credit is a 65 percent increase in value per District resident. (Only 75 percent of the employees were District residents in the example.)
[7] As another example, consider a firm with 100 employees that rents 22,000 sq. ft. of prime office space at $32 per square foot. If 50 percent of the employees are District residents, the business will generate $150,000 of tax credits — an average $1,500 per employee. The value of the tax credit is equal to 21 percent of the rental cost. If the value of the tax benefits were shared equally by the lessor and lessee, the rent of that property would rise by more than 10 percent.
[8] The attraction of criminal activities as an alternative to legitimate work for residents of inner-city neighborhoods is discussed in Wilson, 1997.
[9] The District government does, however, incur substantial federal Social Security and unemployment taxes on the wages it pays to its employees.
[10] A nonprofit organization that engages in business that is not related to the exempt purpose of that organization must pay corporate income tax on what is known as "unrelated business income" (UBI). Tax-exempt organizations that have UBI could benefit from tax benefits available to corporations.
[11] No credit is available for any in-house training expenses.
[12] For the equivalency to hold, the underlying investment has the same rate of return as the investor's borrowing rate. In general, this is the case, but as discussed below, there are important exceptions.
[13] A business that did not have current taxable income would receive some benefit from expensing if it were to become taxable in later years. But these benefits are small. For example, if a business invests $20,000 in equipment with a five-year depreciable life, and that business does not become profitable until three years after that property

was placed in service, the business would get a tax benefit with only one-eighth the value of what it would have been if the business were always fully taxable. In this case, the value of the credit could be less than $100 for the $20,000 investment.

[14] Ironically, the availability of expensing can be a disincentive for increasing investment. For example, suppose a firm is considering expanding its qualified investment from $200,000 to $250,000. Because $200,000 is the beginning of the phase-out range, this firm would lose tax benefits if it increased investment.

[15] Businesses also are subject to an overall enterprise zone volume cap of $20 million. For example, if a national chain already had $12 million of enterprise zone bonds outstanding relating to investments in other empowerment zones and enterprise communities, that business would only be eligible for $8 million of enterprise zone facility bonds in the District. (In general, businesses are subject to a $3 million per-zone limitation. The $15 million of exempt financing available to each business in the D.C. enterprise zone is an exception to that rule.)

[16] One reason the new enterprise facility bonds may be of little value to the District is that many types of facilities that might qualify as enterprise zone facilities can be financed under existing rules. In particular, small issue bonds provide assistance to private businesses seeking financing, but the amount of financing was limited to $10 million per business (as opposed to $15 million for enterprise facility bonds) and many types of nonmanufacturing businesses were not eligible. The proceeds of qualified redevelopment bonds can be used for local government acquisition and rehabilitation in "blighted areas," but cannot be used for new construction. The ability to issue exempt facility bonds does, however, give the District more versatility in its choice of private activity bond financing.

[17] Larry Summers, a former Harvard economics professor and now deputy secretary of the Treasury, has argued that IRAs increase personal saving not because of any inherent financial rewards, but because banks invest heavily to advertise IRAs.