CENTER *for* RURAL POLICY *and* DEVELOPMENT

*Seeking solutions for Greater Minnesota's future*

# *Understanding Job Opportunity Building Zones*

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## *Introduction*

One of the first bills introduced in the 2003 legislative session was House File 3, a bill to create Job Opportunity Building Zones, tax-free zones intended to spur economic development in distressed rural areas of Minnesota. A similar bill was submitted in both the 2001 and 2002 legislative sessions by then-House Majority Leader, now Governor, Tim Pawlenty. While these previous versions did not pass, the current bill authored by Rep. Doug Magnus has more than 30 co-authors and appears to have strong support from the House leadership. In addition, a companion bill, Senate File 496, has now been introduced in the Senate by Sen. Thomas Bakk.

Tax-free zone programs are currently operating in Michigan, where they are called Renaissance Zones, and in Pennsylvania, where they are called Keystone Opportunity Zones. When closely examining both H.F. 3 and S.F. 496, it becomes clear that many of their operational concepts have been adopted from both the Michigan and Pennsylvania programs.

In late February, H.F. 3 experienced a rewrite through a delete-all amendment and replacement. Accordingly, this policy brief will attempt to provide comments on the original bill, the amended H.F. 3 and S.F. 496. It is not the intent of this policy brief to endorse or not endorse either of these bills or the concept. Rather, its intent is to help policy makers and local officials better understand the concept and the implications of tax-free zones for their communities.

## *What are Job Opportunity Building Zones?*

Just like tax increment financing, tax abatement, or any other tax incentive oriented toward business development and investment, tax-free zones provide incentives for businesses to start up, expand, or relocate to a specific designated area. However, there are two primary differences: First, unlike other tax incentives, tax-free zones do not target specific industries or types of businesses. Second, a tax-free zone program is a much more aggressive type of incentive, since it allows a business or individual residing in a designated zone relief from a large majority of state and local taxes.

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**Taxes exempted in a JOB Zone**:

The specific tax exemptions provided in H.F. 3 include property taxes, corporate franchise taxes, income taxes, sales taxes, wind energy production taxes and the motor vehicle sales tax, if the vehicle is garaged in a zone and primarily used in support of an operation located in a designated zone. Wind energy production taxes are not exempted in S.F. 496. The tax exemption does not apply to debt obligations by the local jurisdiction through the servicing of existing general obligation bonds, or existing school operating levies. Further, to be eligible for these tax exemptions, the individual or business cannot be tax delinquent. Consequently, individuals and businesses cannot relocate to tax-free zones to escape back taxes. In addition to these tax exemptions, H.F. 3 proposes a jobs tax credit for higher paying jobs created in a designated JOB Zone. This tax credit provision is not included in S.F. 496.

**The number and size of tax-free zones:**

Both S.F. 496 and H.F. 3 call for the Commissioner of the Department of Trade and Economic Development, in consultation with other state agencies, to designate up to ten JOB Zones, with each zone no bigger than 5,000 acres. Within each JOB Zone, the local jurisdiction(s) can designate subzones, which can be non-contiguous but cannot equal more than 5,000 acres combined (the maximum size of a JOB Zone). Language on the size and number of these subzones differ between the bills. Originally, H.F. 3 allowed up to six non-contiguous “subzones” of at least 20 acres each, and this provision is still intact in S.F. 496. The amended version of H.F. 3, however, no longer contains specific language regarding the number or size of subzones.

Being able to create several subzones within larger tax-free zones may help local officials see better the potential for regional partnerships between municipalities and across county lines. For example, it may not be difficult to imagine three or more contiguous rural Minnesota counties applying as one single tax-free zone, with multiple subzones within its jurisdiction. Such partnerships could possibly change the paradigm of economic development from a local to a regional one. Accordingly, the legislation affords local jurisdictions the opportunity to be creative in their economic development relationships in ways not previously considered. These subzone designations are not unique to Minnesota: subzones are used in both the Pennsylvania and Michigan programs.

Both H.F. 3 and S.F. 496 also allow for the designation of up to five Agricultural Processing Facility (APF) zones around the state. These APF zones are designed to provide similar tax benefits to manufacturing, sorting and/or packaging facilities that process livestock and animal products, agricultural commodities, or plants and plant products for intermediate or final consumption, regardless of their food or non-food use. Such language suggests that facilities such as plant and animal processing plants, ethanol and biodiesel production facilities, and paper and forest products manufacturing plants would be eligible. Unlike JOB Zones, the size of an APF zone is not limited to a specific number of acres. Rather the size of these zones is equal to the size necessary for the agricultural processing facility, along with adjacent land for ancillary operations and future expansion.

**Exemptions on residential property:**

Similar to the programs in Michigan and Pennsylvania, S.F. 496 proposes providing tax exemptions to individuals who reside within a tax-free zone. Eligibility as a zone resident would require a consecutive 184-day, or 6-month residency in the zone in the year the exemption is requested. Such a provision could allow the zone designation to be used as an incentive for new residential developments, as well as opportunities to bring existing substandard residential properties up to code. For example, in Michigan, while 95 percent of all the subzones are zoned commercial/industrial, a few parcels have been zoned residential, including at least one zone that provided the tax exemptions for new, “upper end” housing. And in Pennsylvania, one residential neighborhood consisting primarily of substandard housing was designated as a tax-free zone, but property owners could not realize the tax benefits until their properties were brought up to code.

All references to tax exemptions for residents living within a designated zone were deleted from H.F. 3, making it now strictly a business development bill.

**Length of tax exemption:**

The length of the tax exemptions proposed can vary, but cannot exceed 12 years. The exact length of the zone designation will be requested by the local jurisdiction(s) in their application for zone status. This is similar to Michigan’s program where jurisdictions can apply for a zone status of up to 15 years. However, in Michigan, in the final years of the exemption, businesses return to the tax rolls in 25-percent increments.

Therefore, if a business received a 15-year exemption, in Year 13 the business would receive a 75-percent tax exemption; a 50-percent exemption in Year 14; a 25-percent exemption in Year 15; and in Year 16 the business would be fully back on the tax rolls.

It should be noted, however, that in the other states, the length of the zone's tax exemption has been extended. One may speculate that after a few years, as the length of the zone's tax exemption period gets shorter and shorter, the economic advantage of locating in a zone becomes smaller and smaller. Therefore, after a few years, requests are made to extend the zone's tax exemption to encourage new businesses to locate in these tax-free areas.

## *How the Minnesota program is proposed to work*

**Designating tax-free zones:**

The Commissioner of Trade and Economic Development will designate both JOB Zones and the Agricultural Processing Facility Zones from a pool of applications submitted by local units of government. One or more local units of government can apply jointly for the designation. However, eligibility is restricted to units of government outside of the Twin Cities seven-county metropolitan area.

The local unit or units of government will be required to complete an application that contains:

- The requested size and location of the proposed zone and subzones, including a map;
- The requested duration of the zone (up to 12 years);
- Supporting economic and demographic data about the area;
- A development plan, which indicates the planned economic development strategy for the zone;
- A resolution from the local unit(s) of government supporting the designation; and
- Documentation of widespread commitment from the local public and private sectors.

The Commissioner will prioritize and select applications based on three primary criteria:

- The extent to which the area is economically distressed;
- The quality of the development plan proposed; and
- The likelihood of success in attracting investment and development.

**It is important to recognize that the decision to apply for a tax-free zone designation will be a voluntary one made by the local units of government themselves. While both S.F. 496 and H.F. 3 have a provision for the state to reimburse local jurisdictions for some local tax revenue lost as a result of the zone designation, it is not intended to reimburse all, or even most of this lost revenue (see page 5). Therefore, communities and counties will have to consider carefully whether the potential development and investment opportunities of a tax-free zone outweigh the local tax revenues that property in a zone might have otherwise provided.**

**To demonstrate this point, of the 60 initial communities in Michigan eligible to apply for a tax-free zone designation, only 20 did so. This strongly suggests that many of the eligible communities were not yet ready to forego ten or more years worth of tax revenues.**

**Addressing Business Relocations:**

One concern often expressed by local development practitioners and policy makers is that such a tax incentive program does not necessarily create new business opportunities, but rather, the employment and development gains realized in the zones are simply from businesses that have relocated from someplace else in the state. Therefore, there is no net employment gain statewide, simply a rearranging of existing businesses.

H.F. 3 and S.F. 496 do not restrict a business from relocating to a tax-free zone from another location in Minnesota. However, the bills stipulate that for the relocating business to receive the desired tax exemptions, it must increase its number of full-time employees by at least 20 percent in the first year, or it must make a capital investment in the property equal to at least 10 percent of the business's annual gross revenues. If a business simply relocates to a tax-free zone and does not expand its employment base or make these capital investments, it will not be awarded the tax exemptions. This provision was adopted from the Pennsylvania program.

Further, both H.F. 3 and S.F. 496 has a penalty provisions for the repayment of tax benefits equal to those received during the previous two years in the event that a business ceases its operations in a tax-free

zone. Such repayment of taxes would apply only to businesses that relocated to the zone after its designation.

**The Michigan and Pennsylvania Experiences:**

While Minnesota's plan is proposed as a rural economic development strategy, the programs in Michigan and Pennsylvania contain both rural and urban tax-free zones. In fact, when Michigan initiated their program with 11 Renaissance Zones in 1996, only three were rural. And in Pennsylvania, of the 12 multi-county Keystone Opportunity Zones established, only one was comprised of counties without a Metropolitan Statistical Area (MSA). As the Minnesota program is designed to assist only economically depressed areas of *rural* Minnesota, direct comparisons to the other states may not be as instructive, due to the influence of their metropolitan areas. Consequently, much of the discussion here regarding the outcomes in Pennsylvania and Michigan will attempt to focus exclusively on their rural zones.

## JOBZ bills at at glance

| Issue | H.F. 3 | S.F. 496 |
|---|---|---|
| Maximum size of zone (acres) | 5,000 | 5,000 |
| Maximum number of subzones | None | 6 |
| Minimum size of subzones | None | 20 acres |
| Maximum length of exemption | 12 years | 12 years |
| Residential tax exemptions | No | Yes |
| Agricultural Processing Facilities Zones | Yes | Yes |
| Job production tax credit | Yes | No |
| Wind energy production tax exemption | Yes | No |
| Mechanism for reimbursement to local governments | Yes | Yes |

**North Central KOZ**: Pennsylvania's Keystone Opportunity Zone (KOZ) program was initiated in 1999, expanded in 2000 and expanded again in 2002. As mentioned above, only one of the 12 KOZ zones is truly rural, meaning that there are no metropolitan statistical areas within the zone's borders. This zone, the North Central Zone, consists of the counties of McKean, Potter, Elk, Cameron, Jefferson and Clearfield. Within these six counties the largest community, St. Marys, has a population of approximately 14,500. The zone originally consisted of 1,836 acres and was nearly doubled through expansion to its present 3,271 acres. Within this six-county zone there are 20 subzones.

Recent data from the Pennsylvania Department of Community and Economic Development (DCED, 2002) documents 50 projects occurring across the 20 rural subzones since 1999. The DCED documents 877 jobs created, 1,576 jobs retained and approximately $93 million in capital investment in the North Central Zone. However, it is important to note that there is no delineation between full-time and part-time jobs. Further, this investment figure includes both actual capital investments and planned capital investments and it is impossible to distinguish between the two.

Among the 50 documented development projects in the North Central KOZ, 18 percent were attributed to new business start-ups, 10 percent were out-of-state business expansions or relocations, and 72 percent were in-state business expansions/relocations. Among the 877 new jobs created, 14 percent were from business start-ups, 23 percent were from out-of-state business expansions or relocations, and 63 percent were from in-state business relocations. It is interesting to note that approximately 50 percent of the jobs created from out-of-state expansions were the 100 jobs created from a new Wal-mart Supercenter located in a Jefferson County subzone.

While the majority of the $93 million of capital investment cited was private, it should be noted that $9.5 million (or 10%) of the capital investment cited was public investments through the construction or renovation of structures such as State Patrol offices and DOT regional offices and maintenance facilities. However, it is reasonable to conclude that the majority of employment in the zone as well as the majority of investment was from the private sector.

**Michigan's Rural Zones:** Of the first 11 tax-free Renaissance Zones designated in Michigan, three were

rural (Sands, 2002). These were the Gratiot/Montcalm Zone, the Manistee Zone and the Upper Peninsula Zone. Further, among the first 45 subzones designated, 14 were located within these three rural zones.

Documents from the Michigan Economic Development Corporation suggest that more than 6,400 jobs have been created or retained and over $1.8 billion in investments have been made as a result of the zones. A recent evaluation released in December 2002 provides detailed project and investment information only through 1999. Consequently, the figures we use below only reflect the first three years of the program's operation (1997-1999).

Overall, the three rural zones experienced 21 projects in the first three years, creating or retaining 594 jobs and creating approximately $49 million in capital investment. The average number of jobs per project across these three rural zones was 28 (31 in the rural KOZ zone). Further, while development opportunities in both Michigan and Pennsylvania were clearly greater in the urban areas, some level of development appeared in the rural zones. For the first three years, approximately 16 percent of projects, 16 percent of the jobs created, and 13 percent of the capital investment were in Michigan's rural zones. The consistent nature of the development in Michigan was noteworthy in that while 13 percent of the projects in Pennsylvania were in the rural North Central Zone, these same projects only netted 6.5 percent of the jobs created and 6 percent of the capital investments.

## *Estimating the cost of tax-free zones*

One concern that many legislators, as well as local government officials have about the establishment of tax-free zones is the cost of the program. The costs are primarily from abated state and local tax revenue and would come from several sources:

- **Taxes abated from existing businesses and properties currently paying state and local taxes that will be exempted when their property is designated as being in a tax-free zone;**
- **Taxes abated from new businesses that will start up, expand or relocate to the tax-free zone after its designation, and consequently will be exempted from paying state and local taxes;**
- **Third, state aid that may be distributed to help reimburse some of the lost revenues to local jurisdictions.**

Estimating the potential costs of such a program is extremely difficult, as one has to rely on a variety of estimates or assumptions regarding what might be and what might happen. First, one must estimate the amount and value of improved property that will be located in the tax-free zone at the time of its designation. Clearly, if an area with a large amount of improvements or even existing businesses is designated as a tax-free zone, then the property, income and sales tax revenues foregone may in fact be quite substantial. On the other hand, if an undeveloped parcel of land in a municipally owned industrial park is designated as a tax-free zone, or if a zone is designated on an existing tax-increment financing parcel, no significant level of taxes are immediately lost.

Second, one must also attempt to estimate the amount of additional new development and investment that may occur throughout the duration of a tax-free zone. These are tax revenues that would be exempted and foregone in addition to the loss of revenue from businesses already located in the zone at the time of its designation.

Finally, H.F. 3 does provide a mechanism to financially aid local governments in the event of a significant tax loss as a result of the tax-free zone designation. Each year the local assessor would be required to calculate the difference between the local taxes that would have been collected from the zone if not for the designation, and the actual taxes collected. If this difference exceeds 3 percent of total net tax capacity for the jurisdiction, the local government would be eligible for financial compensation. However, the local jurisdiction would not receive reimbursement equal to 100 percent of the lost revenues. Again, such local aid would be an additional cost to the state that would need to be factored into any program cost estimate.

In the fiscal note attached to H.F. 3, the Minnesota Department of Revenue has attempted to estimate the costs in taxes forgone to the State's General Fund. This estimate of $4.85 million for the FY 2004-05 biennium ($1.5 million in FY 2004 and $3.35 million in FY 2005) only reflects tax revenues foregone to the state's general fund, and does not include revenues lost to local governments (property taxes foregone) or the costs of administering the program.

When examining such estimates, one needs to directly review the assumptions from which these estimates were constructed. Accordingly, several of these assumptions should be noted, as they will likely affect the ultimate accuracy of the estimate:

- First, it is clear that the Department was working from the original H.F. 3, as they assumed that there would be a maximum of six subzones, each being a minimum of 20 acres in size, within each zone. As this is no longer the case in the amended bill, it is likely that there will be many more than 60 subzones statewide. This will likely raise the cost estimate.

- Second, the Department assumed that all subzones would be designated from vacant land. This could turn out to be a faulty assumption and that smaller, more targeted subzones would be designated on parcels with vacated warehouses, factories and other improved structures. Consequently, this too will likely raise local costs.

- The Department also assumed that there would be residential units located in the designated zone receiving tax exemptions. As this provision is no longer in the bill, it will likely decrease the costs.

- Lastly, the Department assumed that the Job Opportunity Building Zone aid provision in the bill would likely not be enacted, as the level of taxes forgone locally would probably not reach the 3-percent threshold set in the bill. This will likely turn out to be an accurate assumption for the FY 2004-05 biennium.

As suggested above, trying to accurately estimate the costs of these Job Opportunity Building Zones is an exercise in trying to guess what might happen regarding future economic development in the zones. Removing the residential tax-exemption provision in the bill clearly reduces its costs; however, the new provisions in the bill creating wind production tax exemptions and employment tax credits may increase its costs. Consequently, with the available information, we are reluctant to offer an alternative cost estimate.

## *Operational Points to Consider*

Research from both the Michigan and Pennsylvania experience is quite helpful in suggesting ideas that may improve the probability of success in Minnesota if the legislation passes. Below are a number of points we believe are worthy of legislative consideration:

1. **Avoid to the extent possible the politicizing of zone designations:** Clearly, any time a limited resource is to be distributed, accusations of political behavior occur. While such accusations cannot be avoided, they can be minimized. A clear and unambiguous set of criteria regarding zone selection would be very helpful in allowing outside observers to independently evaluate how zone designations were made.

2. **Focus on real, existing development opportunities:** Research in Michigan and Pennsylvania clearly suggests that subzones that included vacated factories, warehouses, quality infrastructure and other improvements were more successful in attracting investment than those zones that included simply unimproved parcels of land. Therefore, a more targeted approach to zone and subzone designation, focusing on real, existing development opportunities may improve the likelihood of success.

3. **Changes in the number and size of subzones:** The amended H.F. 3, which now does not limit the number and size of subzones, will likely maximize cooperation across jurisdictions, as well as allow local economic developers to better target smaller parcels with real existing development opportunities. At the same time, it will likely increase the costs in forgone state and local taxes.

4. **Consider tying the length of the exemption to the business, not the zone:** Currently, once a zone is designated, the “clock” is started on the length of the exemptions. This could have the effect of encouraging businesses to make their investments early, to receive the maximum exemption. However, after a few years have passed, it is likely the tax incentive becomes less and less attractive as the length of the exemption gets shorter and shorter. In fact, it is for this reason that the length of the zone designations has increased in both Michigan and Pennsylvania.

   This phenomenon can be completely avoided by tying the length of the exemption to the business and not the zone. Under such a scenario, if the zone is designated as a 10-year zone, businesses locating in the zone will receive a 10-year tax exemption regardless of their date of entry into the zone, keeping the tax incentive stable over time. After a decade, some businesses will be losing their exemp-

tion and returning to the tax rolls, while other businesses may just be receiving their exemption.

5. **Provide assistance to communities in their application process:** Most rural communities that are economically depressed also tend to have limited human capital resources as well. Therefore it is likely that many of the communities that could most benefit from such a zone designation may not possess the expertise to construct a competitive application. Further, if local jurisdictions are to maximize their cooperation in the application process, hands-on technical assistance to these local units of government would be needed. The current fiscal notes from the relevant agencies (i.e., Revenue, DTED, Planning and Agriculture) do not suggest any such technical assistance. Consequently, we urge the legislature to consider including a mechanism to provide such assistance. Technical assistance can come from DTED regional staff, Planning, regional MnSCU institutions, or elsewhere. But the need for such technical assistance is clear.

6. **Improve the current zone aid provision:** Currently the provision in which state aid is granted to local units of government to reimburse a percentage of their loss in property taxes as a result of the JOBZ program is very modest. In fact, the fiscal note drafted by the Department of Revenue predicts no expenditures from this provision for FY 2004-05, assuming the threshold for aid will likely never be reached. Many economically distressed communities also have very limited tax capacity and likely will find the loss of such revenues for a decade or more a significant burden. Accordingly, some reassessment of this provision may need to be considered.

7. **Include a mechanism to address the type and quality of jobs being created:** While supporters of a tax-free zone do not anticipate this program providing tax exemptions to discount and other "big box" retailers, there is currently no provision in place that would exclude them from receiving such benefits. Further, it is worthwhile to note that such retailers have used tax-free zone benefits in others states. Studies have documented well the difficulties that locally owned retailers have competing with large discount chains and the negative impact such competition creates on Main Street. Consequently, one could argue the rationale of providing additional local tax benefits to such discount retailers.

   Legislators may want to consider the creation of some mechanism to allow local units of government some level of discretion regarding the awarding of these tax exemptions to ensure quality job creation and avoid unfair competition within local markets.

8. **Ensure a quality evaluation of the program in two-year intervals:** One surprising finding in the process of researching information for this policy brief was the lack of objective evaluative data on the overall performance of tax-free zone programs in Michigan and Pennsylvania. Attempts to evaluate the success of such a program requires not only the objective documentation of the jobs created and the amount of private investment, but also the amount of tax abatement that is received at both the state and local levels. Without both pieces of information, it is impossible to evaluate the performance of these tax-free zones. We were surprised that, while the amount of promotional information on the results of the tax-free zones was readily available, it was extremely difficult to identify reliable data on the amount of tax dollars abated (i.e., the costs). Therefore we hope that considerations are given to legislatively mandating an independent evaluation report at the end of each biennium documenting the costs and the results of the program to both the Legislature and the Governor.

## *Conclusion*

In the end, Job Opportunity Building Zones, like any other tax abatement/incentive program, have to be viewed as a tool that may be appropriate in some, but not all, economic development scenarios. It is far from a magic bullet or an "investment magnet." Accordingly, it will likely be evaluated in comparison to other similar but less aggressive tax incentive programs, such as tax increment financing, tax abatement and Border City Development Zones. Measures used to evaluate the effectiveness of these zones should be similar to other economic development programs. These measures would include per-capita job creation costs (e.g., $10,000 per job created); or the ratio of taxes abated to private investment (e.g., $3 of private investment for every $1 of tax abated).

Reports from both Michigan and Pennsylvania seem to suggest that their tax-free zones do create jobs and attract investment. The majority of the jobs and

investment appears to be in the urban zones, but some reasonable level of investment has been documented in their rural areas as well. However, these zones have not had (at least to date) any major transformational impacts. By that we mean that economically depressed areas are still depressed; areas of high poverty are still high; and areas of high unemployment still face employment challenges. But while such transformational effects may take years, zones do appear to help.

It is also important to note that concerns regarding companies relocating within Minnesota to take advantage of these zones have some validity. In Pennsylvania it was found that 72 percent of the projects and 63 percent of the jobs created in the rural North Central KOZ zone were from in-state business expansions/relocations, instead of business start-ups or out-of state relocations.

On the other hand, surveys from businesses located in several Michigan Renaissance Zones suggest that the tax incentives received by locating in a zone improved cash flow and increased business viability. Therefore, there may be some business retention benefit to marginal businesses that would otherwise relocate to an urban area, or potentially go out of business.

It is clear that both Renaissance Zones and KOZ Zones have been quite successful politically. Satisfaction at the local level appears high, even in some communities where only a modest amount of development has been realized. And at the state government level, these programs are quite popular and are being aggressively promoted in national publications and other economic development forums.

However, in spite of all the promotional material on the programs (Michigan reports over 6,400 jobs created and $1.8 billion, while Pennsylvania reports over 13,000 jobs created and $1.58 billion in investment), little information has been released on the public costs of this activity; specifically, the amount of state and local taxes that have been exempted as a result of the program, or the potential negative impacts to neighboring communities that are just outside the zones. Without objective answers to these questions it will be difficult to truly evaluate the “net” value of this strategy.

In closing, as we stated at the beginning of this brief, it is not our intent to endorse or not endorse Job Opportunity Building Zones as an economic development strategy. Rather, we hope this policy brief brings some additional clarity and understanding to state policy makers and local officials regarding these zones and their potential here in Minnesota.