

DEFENSE ECONOMIC READJUSTMENT ZONE

Fiscal Year 2016 Annual Report

SEPTEMBER 1, 2015 TO AUGUST 31, 2016

TEXAS ECONOMIC DEVELOPMENT BANK
Within the Office of Economic Development Finance



OFFICE OF THE GOVERNOR
ECONOMIC DEVELOPMENT & TOURISM

2016 Annual Report

Defense Economic Readjustment Zone Program

Overview

The Defense Economic Readjustment Zone Program was created in 1997 by the 75th Texas Legislature as a tool for business recruitment and job creation in adversely impacted military communities. It is designed to provide assistance to Texas communities, businesses, and workers impacted by, or vulnerable to, the closure or realignment of military installations and the reduction of federal defense contracting expenditures.

Since its inception, six zones and five project applications have been approved by the Texas Economic Development Bank (“Bank”) in the Office of the Governor. Zones are designated for a period of seven years while projects are designated for a period of five years from the date of approval.

Local communities must nominate a company as a Defense Economic Readjustment Zone Project in order to be eligible to participate in the program. Qualified businesses designated as DERZ projects are eligible for a state sales and use tax refund on expenditures of qualifying items. Under DERZ, the level and amount of the tax refund is related to the sales and use tax paid on expenditures of qualifying items and the number of jobs created/retained at the site.

Local communities participating in the program may offer benefits to participants under the DERZ program including but not limited to local property tax abatement, tax increment financing, one-stop permitting, and other incentives. The most common local incentives available in the DERZ communities are tax abatement, infrastructure improvements, and training programs.

In FY 2016, the DERZ program did not receive any applications and currently is not administering any active projects. Also, there are currently no active designations established for the DERZ program. The last zone designation in McGregor expired in September 2015.

Reporting Requirements

In 2003, the Texas Legislature authorized the Economic Development Bank to administer the program. As part of that charge, the Bank is required to submit an annual evaluation report to the Texas Legislature and the Legislative Budget Board, which evaluates the program’s effectiveness, describes the use of state and local incentives and their effects on revenue, and suggests legislation as appropriate (*Government Code, Chapter 2310. Subchapter B, Section 2310.052*). This report is submitted in fulfillment of the program’s statutory requirements:

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Sec. 2310.052. EVALUATION; REPORT. (a) The bank shall conduct a continuing evaluation of the programs of readjustment zones.

(b) On or before December 1 of each year, the office shall submit to the governor, the legislature, and the Legislative Budget Board a report that:

(1) evaluates the effectiveness of the readjustment zone program;

(2) describes the use of state and local incentives under this chapter and their effect on revenue; and

(3) suggests legislation, as appropriate.

Evaluation of Program Effectiveness

Section 2310.052 (b) (1) of the Government Code requires the Bank to evaluate the effectiveness of the readjustment zone program as part of its annual report to the Texas Legislature and Legislative Budget Board.

The program as it currently exists is significantly underutilized by qualifying defense communities. There were no zone or project applications in FY 2016, nor has there been any program activity for the past seven years. There are a number of reasons for this.

First, the process for DERZ designation can be cumbersome and time consuming. Currently, there must be a finding that the area to be designated is located in an adversely affected defense-dependent community and the zones must be created in accordance with the provisions found in *Sec. 2310.105*. If the Bank determines that a nominated area satisfies the criteria, then a designation agreement is negotiated in accordance with *Sec. 2310.107*. It is only after the designation agreement is in place that projects can be nominated as Defense Readjustment Projects.

This procedure currently used for the creation of a DERZ is identical to the former procedure used in the Enterprise Zone program, which was amended by the 78th Texas Legislature to remove the cumbersome zone creation process. Under the updated procedure, enterprise zones are created statutorily thereby streamlining the process and increasing participation.

Second, the statute has not been amended to reflect changes in the definition of Adversely Affected Defense-Dependent Community found in *Sec. 2310.102*. Existing language does not allow the program to be used in areas to support our defense industries without first finding the area was adversely affected. This effectively eliminates the areas where defense growth and spending is driving economic activity. The original language envisioned a loss of military related economic activity and substituting it with other economic activity. Consideration should be given to using the

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program to capitalize on enhancements to the military related activities (i.e. Federal contracting possibilities, military base expansions, etc.).

Finally, the program is limited in terms of the types of expenditures that qualify for incentive rebates. Unlike the Enterprise Zone, in which the rebate of state sales & use tax is given for any sales & use tax liability paid, the rebates in the DERZ program are restricted to:

- (1) the purchase, lease, or rental of equipment or machinery for use in a readjustment zone;
- (2) the purchase of material for use in remodeling, rehabilitating, or constructing a structure in a readjustment zone;
- (3) labor for remodeling, rehabilitating, or constructing a structure in a readjustment zone; and
- (4) electricity and natural gas purchased and consumed in the normal course of business in the readjustment zone.

The program would be more effective as an economic incentive tool if the refund was applicable for any sales and use taxes incurred in the project site.

Use of State and Local Incentives and Effect on Revenue

Section 2310.052 (b) (2) of the Government Code requires the Bank to describe the use of state and local incentives under this chapter, and their effect on revenue as part of its annual report.

State legislation allows communities to offer a number of local incentives to DERZ projects including:

- (1) A refund of local sales & use taxes;
- (2) Reduction or elimination of local fees or taxes;
- (3) Tax increment financing and abatement;
- (4) The issuance of development bonds; and
- (5) Other local incentives delineated in 2310.409.

Due to the lack of applications received during the 2016 fiscal year, there were no local incentives granted to projects under the program and therefore there were no effects on local revenues.

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Recommendations to Improve Participation

Section 2310.052 (b) (3) of the Government Code requires the Bank to suggest legislation as appropriate as part of its annual report.

In order to make DERZ a more effective program, the following changes should be considered:

- (1) Update the provisions in the act relating to the creation of the Zones. Defense Economic Readjustment Zones could be created by statute in the same manner as in the Texas Enterprise Zone Program.
- (2) Consider updating the definition and requirements for projects to be located in Adversely Affected Defense Dependent Communities.
- (3) Amend the statute to allow rebates on state sales & use tax for any state sales & use tax paid for eligible projects.

Also, the DERZ statute should be amended so that the program report is incorporated within the annual Bank Report due on January 1 of every year instead of a stand-alone DERZ report due on December 1 of every year.