Order Code RL33088

CRS Report for Congress
Received through the CRS Web

Tax Policy Options After Hurricane Katrina

September 16, 2005

Jane G. Gravelle
Senior Specialist in Economic Policy
Government and Finance Division

Tax Policy Options After Hurricane Katrina

Summary

The damage from Hurricane Katrina raises at least four issues that might be addressed by tax policy.

The first issue is that the effect of the disaster, particularly given the potential impact on energy prices, might contract the overall economy, suggesting some need for a fiscal stimulus. The Administration has indicated that it will not propose a tax cut, but supports making the existing tax cuts permanent.

Preliminary indications are that the effect of the hurricane on the national economy will be limited. Even if a stimulus were needed, there are many problems with relying on tax cuts (rather than spending or a monetary stimulus), given the difficulties in delivery of a tax cut. The Administration proposal is unlikely to have an effect, since the tax cuts do not, in general, expire until 2011 and there will be no immediate effect on disposable income.

A related nationwide fiscal policy concern is that the loss of income (and the taxes on that income) and the increased spending will worsen pressures on the budget. A tax cut would exacerbate that effect.

A second issue is whether the rise in energy prices should be addressed by some redistribution from energy producers to consumers, or some general relief. One proposal that has been made, to suspend the gasoline tax, would not be expected to have an effect on prices in the short run, but would rather increase profits of producers. Income tax rebates could be used to target poor people, but this approach, as with a stimulative tax cut, faces administrative difficulties. Proposals have been made for a windfall profits tax, which has some historical precedents, but the tax is difficult to administer.

A third issue is whether or not tax measures might be used to provide relief for the victims. In general, tax benefits cannot easily be targeted to lower income individuals. There are some current tax provisions and recent administrative actions that are already providing some relief. Two bills in the House (H.R. 3768) and the Senate (S. 1696) would provide additional benefits to help with cash flow, employment, housing, and tax compliance issues of the victims, as well as incentives to increase charitable giving. While some of these proposals will aid the victims, or at least moderate and higher income victims, little of the cost of tax benefits for charitable giving in the Senate bill is likely to do so.

A fourth issue is what role tax subsidies might play in the longer term rebuilding of the area. Geographically targeted subsidies exist in the current tax law for economically depressed areas and were enacted for lower Manhattan after the 2001 terrorist attacks. Empirical evidence suggests that these incentives might not be very effective in speeding up or increasing the degree of rebuilding but they may be desirable as part of the means of compensating victims for catastrophic losses.

This report will be updated to reflect legislative developments.

Contents

Tax Cuts and Fiscal Policy Issues 1

Providing Relief from High Fuel Prices 4

Providing Relief to the Disaster Victims 5
Existing Tax Provisions 5
Administrative Actions of the Internal Revenue Service 6
New Proposals 6
Discussion of Tax Proposals for Relief 8

Incentives for Rebuilding 10
Current Geographically Targeted Subsidies 10
Justification for Subsidies 11

Conclusion 13

Tax Policy Options After Hurricane Katrina

The damage from Hurricane Katrina raises at least four issues that might be addressed by tax policy. This report provides an overview, beginning with national issues and then addressing local issues.

A first issue is that the effect of the disaster, particularly given the potential impact on energy prices, might contract the overall economy, suggesting some need for a fiscal stimulus. A related nationwide fiscal policy concern is that the loss of income (and the taxes on that income) and the increased spending will increase the budget deficit and debt, and worsen pressures on the budget from a variety of factors (such as the Iraq War and the need to address issues such as the alternative minimum tax). A second issue is whether the rise in energy prices should be addressed by some redistribution from energy producers to consumers, or some general relief. A third is whether or not tax measures might be used to provide relief for the victims. The final section discusses the role that tax subsidies might play in the longer term rebuilding of the area.

Tax Cuts and Fiscal Policy Issues

Hurricane Katrina had devastating effects in areas of Louisiana, Mississippi, and Alabama. It will also have effects on the overall economy. These effects arise from two sources: from the direct losses in the area and from possible supply effects for the economy as a whole, mainly fuel costs. The extent to which Hurricane Katrina might adversely affect the economy thus depends significantly on how energy issues are resolved. The loss of property from the disaster per se cannot be reversed and does not in itself imply a problem with unemployed resources which is the reason for general economic contractions that might be addressed by a fiscal stimulus. The residents of the affected region are displaced from their jobs, but a more targeted method to address this problem is to provide direct spending (in the area of impact and the area that is housing refugees) to return these workers to their jobs. Lingering unemployment in the area will be offset in part by increased demand for workers due to the rebuilding efforts.

Pressure on energy prices remains a concern. A recent release by the Congressional Budget Office (CBO), however, indicated that the outlook was becoming somewhat more positive as the energy infrastructure was being restored.[1] This study estimated a small one-time reduction in output and a temporary slowing of growth (but not a recession) with growth projected to turn up in the first half of

---

[1] Congressional Budget Office, *Macroeconomic and Budgetary Effects of Hurricane Katrina*, September 6, 2005.

2006 as rebuilding resumes. These losses are relatively small because the production in the affected area is small compared to the U.S. economy and because of the expected resolution of the energy shock.[2]

The Internal Revenue Service (IRS) has already undertaken some administrative actions that might ease the fuel situation (and some regulatory changes and a release of oil from the strategic reserve have also occurred). These administrative actions include allowing the sale of dyed diesel fuel for highway use (normally reserved for off-road or tax exempt use), suspending the tax penalty on failure to meet sulphur content regulations if the EPA waives the requirements, and allowing highway vehicles to remove aviation fuel from tax favored airport fueling terminals for certain airports in New Orleans, Memphis, Dallas and Houston. The IRS and Treasury have also announced that transporting fuel from the strategic oil reserve will not disqualify shipping operations for exemption from U.S. income tax under treaty agreements.

Federal spending already authorized or proposed constitutes a regionally concentrated stimulus. As for broader tax policy, Treasury Secretary Snow indicated on September 2 that the Administration will not propose a tax cut to stimulate the economy. Rather, they continue to propose that Congress make the 2001 tax cuts permanent, arguing that this change would increase confidence in the future.

Making the tax cuts permanent would have not have much effect on demand. Most of the tax cuts would not take effect until 2011 when the rate reductions and other revisions expire (the lower rates on dividends and capital gains expire in 2009), and would not increase current disposable income. Although there are theories that increases in permanent income will affect current spending, there is evidence that a substantial amount of current spending is related to current income. In addition, if individuals already believe the tax cuts will be permanent their behavior would not be affected. And much of the benefit will go to higher income individuals who are less likely to spend income, especially the rate reductions, the estate tax repeal, and the lower taxes on dividends and capital gains.

The most effective way to stimulate the economy through fiscal measures is to increase direct spending, or to provide tax cuts to people who are likely to spend most of it, which are likely to be lower and moderate income individuals.[3] (Monetary policy can also be used to stimulate the economy.) Since the lowest income groups do not pay income taxes, only measures directed at earned income tax credits or refundable child credits are likely to reach these individuals.

Moreover, even if the tax cut can be directed at taxpayers who are likely to spend it, the tax system has a number of constraints that prevent it from being an

---

[2] See CRS Report RS22260, *The Macroeconomic Effects of Hurricane Katrina*, by Brian W. Cashell and Marc Labonte for a further discussion of the likely economic effects and a summary of forecasters' projections.

[3] See CRS Report RS21126, *Tax Cuts and Economic Stimulus: How Effective are the Alternatives?*, by Jane Gravelle, for a further discussion of the savings and spending behavior of lower and higher income individuals and references to empirical evidence on this point.

effective immediate fiscal stimulus tool. There is a lag in passing legislation and a lag in getting money to individuals. Tax rules generally cover an entire year, tax returns are filed with a lag, and the usual way to get tax cuts to individuals is through a change in withholding.

The difficulty arising from this route to delivering a tax benefit was illustrated by the 2001 tax cut, which provided for a new 10% rate bracket for 2001. Because the tax cut was adopted towards the middle of the year, reducing withholding in the normal way for the last half of the year would delay the stimulus until taxpayers filed returns the following year. Another option was providing a double reduction in withholding, but this approach would then require an increase in withholding at the beginning of 2002.[4] The solution adopted was to provide rebate checks, which were issued from July to October. There was, however, some concern among economists that lump sum amounts, such as the rebate checks, might not be spent because they would be viewed as a one time effect on wealth.[5] One study of the rebate found that about 20% to 40% was spent on nondurable goods in the three months in which the check was received and another third in the following three months.[6] These results suggest that a significant amount was spent quickly (although well under the 100% of spending that would occur with a direct spending program). This study also found that spending was greater for those households that had low levels of wealth, consistent with other evidence that lower income (and wealth) individuals have a higher propensity to spend.

On the whole, therefore, it is not clear that a stimulus is desirable, and even if it is desirable, tax cuts may not be the best option. The administration's proposal to make the tax cuts permanent is unlikely to have an effect.

Tax cuts of any type can, however, worsen the long-run fiscal situation of the country. The increased spending on Iraq, other spending needs, addressing problems arising with the alternative minimum tax, and extending expiring tax cuts lead to a significant continuing deficit.[7] In the longer run, the pressures of spending for Social Security and Medicare continue.

---

[4] See CRS Report RS21171, *The Rate Reduction Tax Credit in the Economic Growth and Tax Relief Reconciliation Act of 2001: A Brief Explanation*, by Gregg Esenwein and Steven Maguire for a discussion of the 2001 rebate and the reasons for it.

[5] This issue was discussed in a Congressional Budget Office study, *Economic Stimulus: Evaluating Proposed Changes in Tax Policy*, Jan. 2002.

[6] David S. Johnson, Jonathan Parker, and Nicholas Souleles, *Household Expenditure and the Income Tax Rebates of 2001*, NBER Working Paper 10784, Cambridge, MA, National Bureau of Economic Research, September, 2004.

[7] For a discussion, see CRS Report RS22045, *Baseline Budget Projections Under Alternative Assumptions*, by Gregg Esenwein and Marc Labonte.

Providing Relief from High Fuel Prices

Another issue is whether the tax system can be used to provide relief from high fuel prices.

One type of proposal that would probably not be effective is reducing current excise taxes, such as the federal gasoline tax (which is currently 18.4 cents per gallon). The spike in prices has been caused by a contraction in supply which in the short run is unlikely to be responsive to tax reductions. The higher prices are needed to equate supply and demand. With a more or less fixed supply, any reduction in fuel taxes is likely to increase the profits of suppliers rather than bring down prices. That is, the amount of gasoline consumers want depends on the price they pay, and only one price will equate that amount they wish to purchase to the fixed amount available to sell. If, given a tax repeal, sellers don't add on the tax, effectively lowering the price, consumers will want more than is available, gas stations will run out of gasoline to sell, and either raise the price again, or demand more from their suppliers (who will raise the supply price), and so forth. Essentially any attempt to provide relief through lower prices is likely to fail; relief can be provided in general to ease the circumstances of consumers, especially low income consumers, but not by price reduction.

Transportation officials and lawmakers are also concerned about the loss in funding to federal highways if gasoline taxes are reduced.

Another approach is to target general relief to lower income individuals. The group that may be particularly burdened by higher gasoline prices are low income workers, who may need to drive to get to their jobs. They might be reached through a temporary increase in the earned income tax credit. As in the case of any tax rebate, the challenge is to get money to these individuals quickly. It might be possible to provide the rebate if it is based on the earned income credit claimed on 2004 tax returns, as was the case with the 2001 rebate, which depended on 2000 tax returns.

There are also proposals to impose a windfall profits tax that might be used to fund rebates. A windfall profits tax was imposed in the 1970s and was basically not a tax on profits but an excise tax on oil. It applied to crude oil prices in excess of a base. The tax was somewhat complicated to administer and was designed to impose the tax on existing oil supplies, without discouraging new drilling or marginal production. (A true excess profits tax that is based on profit or other measures as a percent of assets, similar to taxes imposed in World War II, is extremely difficult to design and administer, and has not been proposed.)[8]

One administrative change that might help a narrow group of people is the IRS's recent increase in the mileage rate for deducting costs of operating a car for business purposes from 40.5 cents to 48.5 cents for the last four months of 2005. This rate is also used by the government and many businesses to reimburse employees.

---

[8] See CRS Issue Brief IB10054, *Energy Tax Policy*, by Salvatore Lazzari for a history of the windfall profits tax.

Providing Relief to the Disaster Victims

In many ways, the tax system is not well suited to helping the victims in disaster areas, and direct aid may be more successful. Many low income people who may be the most needy do not pay taxes. Only new provisions that allow refundable tax benefits would be of assistance to them. As with other short term uses of the tax system, enacting and distributing tax benefits is difficult, and tax benefits that are limited by region present administrative problems.

Some provisions that already exist in the tax law can aid victims of the disaster, although the benefits are more likely to be concentrated among higher income individuals. There are also some administrative actions that IRS has taken, largely to extend tax filing requirements. There have also been a number of proposals for tax provisions that are aimed at helping victims of Katrina, some of them directed not at the victims, but at those assisting the victims.

Existing Tax Provisions

Current tax law contains provisions allowing for the deduction of uninsured losses and has some special rules for losses in presidentially declared disaster areas. Casualty losses relevant to hurricane Katrina would include destruction due to wind and floods, and also would include theft. These losses also include property loss due to government ordered demolition because the property is unsafe. Another provision of the law allows certain exclusions for disaster relief payments.[9]

Casualty losses fall into three categories that are treated differently: business losses, employee related losses, and personal losses. Business losses might include the loss of, or damage to, business property or other business assets (such as tools, automobiles, etc.) and loss of inventory. Employee-related losses might include an automobile used for business purposes. Personal losses include damage to homes, furnishings, and automobiles.

Casualty losses for businesses are allowed in full and are deducted like any other costs, including provisions that allow carrybacks and carryforwards of losses. Employee and personal losses are itemized deductions. Employee-related losses are reduced by 2% of adjusted gross income. Personal losses are reduced by $100 plus 10% of adjusted gross income. There are complex rules which deal in part with the fact that gain on appreciated property has never been taxed (so that the loss is limited to the cost basis of the property, generally the acquisition cost less depreciation plus improvements). There are provisions that allow the taxpayer to postpone gain when insurance payments are greater than the adjusted basis which are extended to four years for homes and two years for businesses in a disaster area.

---

[9] See CRS Report RS22249, *Income Tax Relief in Times of Disaster*, by Pamela Jackson. A more detailed discussion can be found in IRS Publication 547, *Casualties, Disasters, and Thefts,* available at [http://www.irs.gov].

Losses in areas that are presidentially declared disaster areas can be deducted in the tax year preceding the loss, so that taxpayers with a loss from hurricane Katrina can file an amended 2004 tax year return to claim a refund.

If part of a federal disaster loan is canceled, it is a reimbursement and reduces the casualty loss deduction.

Disaster relief grants in general that reimburse property losses or medical expenses reduce casualty and medical expense deductions. Qualified disaster relief grants made for other purposes (such as living expenses, funeral expenses) are not taxable under either income or payroll taxes. Wage replacement payments, such as unemployment insurance, are taxable.

Administrative Actions of the Internal Revenue Service

The IRS has the authority to postpone for up to a year tax deadlines for income and employment tax filing and payments (and abate interest), and for making contributions to an IRA. Eligible taxpayers include individuals whose main home is in the disaster area, businesses whose principal place of business is in the area, relief workers from government or philanthropic organizations, and businesses and estates or trusts with tax records in the disaster area.

The IRS has already announced a number of actions in response to the disaster. It created a toll free telephone number for taxpayers in the disaster area, 866-562-5227, and waived fees for taxpayers requesting copies of their tax returns. It extended filing deadlines in the disaster area to January 3, 2006 and expanded the areas eligible. It also postponed certain filing requirements for charities and tax exempt bond issuers and, with other agencies, extended the deadline for making mandatory contributions to pension plans.

Current law allows tax credits for low income housing that taxpayers are eligible for if their properties are largely rented to qualified individuals. The Treasury Department and IRS announced (news release IR-2005-92) that they will allow owners of low-income housing anywhere in the United States to shelter victims who do not qualify as low income, temporarily suspending income limits and non-transient requirements.

New Proposals

There are several legislative changes that might be considered or have been considered in the past. One action that has been taken in the past relaxes the rules for mortgage revenue bonds.

Under current law, states can issue tax exempt bonds to provide mortgages for low income renters who purchase homes below a price ceiling and have not lived in their own home in the past three years. To qualify, 95% of the mortgages in a bond issue must meet income, price, and the three-year requirements. The three-year rule means that the benefit largely accrues to first-time home buyers, and this restriction is often referred to as a first-time home buyer restriction. The purchase price requirement limits the price to 90% of the average price of homes, and the income limit restricts income to 115% of median income, with some adjustments for small families and areas where housing costs are high relative to income. These rules are waived for a portion of loans in economically distressed areas.

In the Taxpayer Relief Act of 1997, a provision was adopted to waive the three-year rule for disaster areas, allowing existing homeowners to qualify. In addition, the rules for economically distressed areas were applied with respect to the price and income limits. The provision was, however, made temporary, and expired after 1998.

Senate Finance Committee Chairman Grassley and Ranking Democrat Baucus have proposed a tax relief bill (S. 1696) that includes the mortgage revenue bond provision and a number of other provisions. The package includes housing assistance (allowing a personal exemption for taxpayers who house dislocated individuals) and provisions dealing with cash flow, employment, charitable giving, casualty losses, and administrative issues. This bill was passed on September 15.

Two categories of provisions are aimed at providing increased cash flow to residents of the disaster area. One provision would exempt the forgiveness of debt due to the hurricane damage (forgiveness of debt is normally considered taxable income). The remaining provisions would reduce barriers to access funds in retirement plans and Individual Retirement Accounts (IRAs). The penalty for early withdrawals from retirement plans such as IRAs and 401(k)s would be eliminated, and the income tax on these amounts paid over three years rather than one. These amounts could also be recontributed in the next three years and treated as rollovers. Loan limits would be increased and payments could be deferred.

Employment related proposals would qualify residents of the disaster area who became unemployed as a result of the hurricane for the work opportunity tax credit (WOTC) which provides a credit to employers, generally at 40% of wages, of up to $2,400 for hiring eligible workers. The proposal would also provide a credit for employers in the disaster area for 40% of wages paid until the end of the year.

The following tax benefits for charitable donations would be allowed through the end of the year. Corporations could deduct the full cost of food inventory donated to charity (currently they may deduct the cost of producing the food plus one half of the value over cost). The restriction that the deduction can be no more than twice the cost is retained. A similar provision is allowed for donations of book inventory. Provisions allowing a rollover of IRAs into charities for individuals age 70 and ½ and allowing rollovers of IRAs of those 59 and ½ to a charitable remainder trust without including the proceeds in income. This provision would benefit taxpayers who do not itemize and reduce income for purposes of determining when Social Security payments are taxable. The limit on cash contributions as a share of income that can be deducted by individuals would be increased from 50% to 60%. A provision that would be allowed through the end of 2006 would increase the limit on charitable contributions of corporations from 10% to 15% of taxable income. The proposals would also allow IRS to disclose information to state officials about denying tax exemption status to organizations or other actions, and would increase the mileage rate deduction for charitable volunteers.

Other proposals include eliminating the 10% percent floor on deducting casualty losses and extending the replacement period for both business property and homes to five years for Hurricane Katrina losses. The proposal would also dedicate fees from certain letter rulings to IRS for disaster relief, extend the authority of IRS to post pone deadlines until February 28, 2006, and clarify that the extension includes employment and excise taxes as well as income and estate and gift taxes.

Also on September 15, the House passed H.R. 3768 (sponsored by Congressman McCrery). This bill had a number of provisions identical to or similar to the Senate plan. The bill lifts the three-year requirement for mortgage revenue bonds, allows families who provide housing for dislocated persons a $500 deduction for each dislocated person, exempts forgiveness of indebtedness from income, and allows the IRA and pension benefits but with a $100,000 ceiling. The WOTC coverage was expanded, but allowed only to employers in the disaster area for individuals who lived in the disaster area before the hurricane. The proposal eliminates both the $100 and 10% floors from the casualty loss deduction and extends the replacement period to five years.

The charitable provisions were more limited and targeted to hurricane relief. Cash donations related to Hurricane Katrina are exempt from the 50% income limit and the phase-out of itemized deductions if made in 2005; similarly, the corporate limit is waived for cash donations related to the hurricane. The bill would also increase the mileage reimbursement rate for charity volunteers.

H.R. 3768 also contains a provision that holds families harmless against the loss of tax benefits due to temporary relocations by allowing the option of calculating the earned income and child credit based on 2004 income. The Treasury Department is also given the authority to ensure taxpayers do not lose dependency exemptions or child credits because of relocations.

The Joint Committee on Taxation has estimated the House bill to cost $5.2 billion over 10 years, with the casualty loss deduction the single largest item at $2.4 billion. No estimates have been released for the Senate bill but it will be more costly.

Discussion of Tax Proposals for Relief

These tax proposals would have effects that are different from direct spending measures, because of both distributional effects and targeting. First, in many cases they will be specifically focused on higher income individuals. Lower income individuals are less likely to have IRAs and 401(k) and other retirement plans, and are more likely to itemize and have homes (and thus benefit from expanded casualty loss deductions). In addition, lower income individuals have lower marginal tax rates and are less likely to have tax liability in general.

The proposals also differ in the degree to which they are targeted to the disaster area. While many of these provisions are targeted, the ones affecting charitable giving are not directed at the disaster area. It is likely that only a small fraction of increased giving is likely to benefit the Katrina victims.

Businesses that donate food and books, and cash, are more likely, for both transport cost reasons and public relations, to donate to causes within their own area. The victims of Katrina tend to be concentrated in Mississippi, Louisiana, and nearby states.

While there has been increased giving to charities that are in the disaster area, a large fraction of individual giving normally goes to causes where little or none of the donations would help Katrina victims. Data also indicate that increased giving to charities that are aiding hurricane victims is already declining,[10] an expected outcome as people become less likely to respond after the height of the crisis. Thus, induced charitable giving is more likely to follow normal patterns. About a third of contributions are made to religious organizations (probably close to half after dealing with double counting of private foundations which are generally not final recipients),[11] and most of this spending tends to go for provision of sacramental services. Similar points could be made about the other important categories of spending.[12] Very high income people, who are more likely to reach the maximum share of giving, may be especially likely to direct their giving to universities and colleges; education is the next highest category of recipient after religion and accounts about 20% of the giving of the highest income classes.[13] Higher income individuals are also likely to give to private foundations and the limited payout requirements of private foundations mean that the money may not be spent for years; even if the limit for giving to private foundations is not lifted, the general limit increase could permit more giving for those who give to private foundations. Wealthy donors are also now using other mechanisms such as supporting organizations and donor advised funds that act, like private foundations, as ways to contribute money now and spread out spending far into the future.[14]

The provision allowing rollovers of IRAs into charitable remainder trusts would have virtually no effects on charitable giving, since a charitable remainder trust leaves a residual amount to charity; that gift is completed only after the individual dies. So, except for the extremely small portion of people who die immediately after setting up the trust, this provision is unlikely to help the victims of Katrina.

---

[10] See Elizabeth Williamson, "Charitable Giving: A Generous Response Tends to Slow," *Washington Post*, Sept.14, 2005, p. A25.

[11] Based on data from Giving USA [http://www.aafrc.org/].

[12] See the articles on different types of charitable organizations in *Who Benefits from the Nonprofit Sector*, edited by Charles T. Clotfelter (Chicago: University of Chicago Press, 1992). For example, data in the article "Religious Organizations" by Jeff E. Biddle (pp. 92-133), indicate that about 70% of spending of religious organizations goes for services (the church building, the minister), and only about 6% goes to poor people.

[13] See Charles Clotfelter, "The Impact of Fundamental Tax Reform on Non-Profit Organizations." In *Economic Effects of Fundamental Tax Reform*, ed. Henry J. Aaron and William G. Gale (Washington, D.C., The Brookings Institution, 1996).

[14] These issues are addressed in testimony by Jane G. Gravelle before the Senate Finance Committee on Charities and Charitable Giving, Apr. 5, 2005.

In addition to this targeting issue, there is some evidence that incentives for charitable giving induce less than a dollar of giving for each dollar of revenue loss, due to a relatively low price elasticity.[15] A temporary benefit may be more effective, but it is likely largely to speed up planned gifts that are not likely to benefit the disaster victims.

For these reasons, revenue lost from financing charitable contribution subsidies is likely to have a negligible effect on aiding victims compared to direct spending or to tax subsidies contingent on being a survivor of the disaster.

While more focused on hurricane relief, these targeted benefits in the House bill may be more difficult to administer.

Incentives for Rebuilding

The final category of tax benefits involve incentives for rebuilding in the disaster area. Government assistance for rebuilding may involve two types of policies. One is grant assistance to rebuild the public infrastructure (roads, schools, etc.) which might include port facilities that were formerly privately owned and might include reconstruction of low income housing. Another policy is to provide tax subsidies for private firms. Mortgage revenue bonds fall into a slightly different category, to provide private subsidies directed at homeowners rather than businesses. In his address on September 15, the President's proposals included a proposal for a Gulf Opportunity Zone that would provide tax subsidies to businesses.

Current Geographically Targeted Subsidies

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

Current tax law contains other geographically targeted provisions often referred to as enterprise zones. (Many states have enterprise zone programs as well.) They comprise 40 empowerment zones (30 urban and 10 rural), 95 enterprise communities (65 urban and 30 rural), and 40 renewal communities. Tax incentives for empowerment zones include a 20% employer wage credit for the first $15,000 of wages for zone residents who work in the zone, an additional $35,000 (above the $100,000 generally allowed) in expensing of equipment investments of qualified zone businesses, and expanded tax exempt financing for certain zone facilities. Renewal communities are allowed a 15% wage credit on the first $10,000 of wages,

---

[15] See CRS Report RL31108, *Economic Analysis of the Charitable Contribution Deduction for Non-Itemizers*, by Jane G. Gravelle for a discussion.

the additional $35,000 in capital expensing, and partial expensing of qualified buildings. Enterprise communities receive tax exempt financing benefits. Schools in enterprise communities and empowerment zones are also eligible for qualified zone academy bonds, where the federal government effectively pays the interest on the bonds. These areas are also eligible for special benefits for cleaning up environmentally contaminated areas (brownfields). There are also special provisions for Indian reservations and the District of Columbia. There is also a new markets tax credit for investors, equal to 5% of the original investment and for the next two anniversary dates, and a 6% credit for the following four anniversary dates, along with capital gains tax benefits for investors.

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

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

Justification for Subsidies

There is a considerable economic literature discussing both the justifications for geographically targeted subsidies to private business and assessing the effectiveness of these subsidies.

Private rebuilding will occur in the absence of tax subsidies, although government construction of essential public infrastructure, such as roads, is vital to any area's recovery. The issue is what speed or magnitude of rebuilding is desirable. Normally the need for subsidies would occur either to achieve distributional objectives or because of market failures — circumstances where an efficient allocation of investment does not occur because of unpriced costs.

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

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

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

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

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

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

A different efficiency objective may also be invoked: aid to devastated areas by the federal government may be viewed as an implicit form of insurance — the country as a whole acts to spread the risk of the cost of natural disasters. If there are imperfect markets for catastrophic insurance, then aid in rebuilding is needed to achieve an efficient allocation of resources. In particular, the cost to businesses in a catastrophe exceeds the loss of property (which can be covered by insurance) because the business also loses its customer base and work force, and it is difficult for private insurance markets to provide coverage for this type of loss.

Until the rationale for the intervention is clear, it is difficult to determine the optimal design or size of subsidies for rebuilding. But if aid is viewed as a nationwide catastrophic insurance program then it is appropriate for the federal government to intervene. Benefits need not be limited to lower income recipients and the measures should probably include a range of subsidies.

Evidence on the effectiveness of subsidies is unclear. There is a significant body of empirical studies focused mainly on state enterprise zones; in general, most of these studies have not found evidence of effects on growth or employment.[16] These results do not necessarily mean that there are no positive effects, but rather that the effects are small and difficult to detect statistically. Specific evidence of the empirical effect of federal programs is virtually non-existent and although some studies have found effects, there are some reservations about their methodology.[17] These results, however, may not be very meaningful for measuring the potential effect of aid to rebuild the disaster area, especially if the motive is not to address a market failure but, effectively, to be part of a catastrophic insurance package.

Conclusion

The use of tax policy to address problems in the aftermath of the hurricane is subject to many limitations. Fiscal stimulus may not be needed, is difficult to implement in a timely fashion, and will add to long-term fiscal pressures. Relief from energy prices is also difficult to address through tax measures. There are some narrowly targeted relief measures for victims that may be effective, but general subsidies for charitable giving are not very target efficient. Longer term benefits to help rebuild the area may be desirable, not so much because they induce giving, but because they constitute part of a national risk sharing activity to deal with catastrophes.

[16] For a brief review, see Leslie Papke, "Enterprise Zones," in *The Encyclopedia of Taxation and Tax Policy*, ed. Joseph J. Cordes, Robert W. Ebel, and Jane G. Gravelle (Washington, D.C.: The Urban Institute, 1999). A new edition is in press and will be available in 2005.

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