The Heritage Foundation Issue Bulletin

No. 100

The Heritage Foundation • 214 Massachusetts Avenue • N.E. • Washington, D.C. • (202) 546-4400

November 17, 1983

ENTERPRISE ZONES: TIME TO ACT

INTRODUCTION

This week's House Ways and Means Committee hearing on enterprise zone legislation marks a long-overdue step toward revitalizing economically decayed urban areas. The hearings are a vital step in establishing federal enterprise zones in the United States. The committee action fulfills a pledge by Chairman Dan Rostenkowski (D-IL), and follows the lead of 19 states that already have enacted similar legislation.

The House committee has been the principal roadblock in the progress of federal enterprise zones legislation. The Senate, for example, passed such legislation earlier this year. But House inaction does not reflect House disinterest. Far from it. The first bill embodying the enterprise zone concept was introduced in the House three years ago by Representatives Jack Kemp (R-NY) and Robert Garcia (D-NY). A new version (H.R. 1955, S. 863) is backed by the Reagan Administration, the original sponsors, and at least 214 House cosponsors from both parties.

This broad support is encouraged by the experience of the states: enterprise zones work and would work far better with federal incentives. Although the first state zones were created only in fall 1982, a survey by the Washington-based Sabre Foundation has discovered strong enthusiasm for enteprise zones within the designated areas, with more than 17,000 jobs created or planned in nine states, and $450 million in new investment.

Some Ways and Means Committee members voice concerns about the cost of the proposed program. They cite Treasury studies putting the loss at $1 billion by 1988 for the proposed 75 zones. Many of the assumptions of this analysis, however, barely resemble the conditions within likely zone sites. The calculations ignore all probable new revenues and welfare outlay reductions resulting from the zones. Consequently, the projected costs are surely exaggerations.

Inertia in the House has been the result mainly of politics. Yet enterprise zones are not a purely White House initiative. It has strong bipartisan support and state versions have been enacted in strongly Democratic legislatures and cities. The concept has the widest endorsement of any urban initiative in years. It is time for the House to move the legislation forward.

THE STATES MOVE AHEAD

Nineteen states have enacted enterprise zone legislation, and a number of others, including New York, Michigan and California, have legislation pending. Eleven have designated zones. Most of these states have established a limited number on a competitive basis, such as Connecticut (6), Illinois (8) and Maryland (6). Zones are now operational in such cities as Chicago, Baltimore and Hartford.

Since the first zones were established only last year, firm data are not yet available. Nevertheless, the initial indications are that enterprise zones work as planned. In particular, local development officials credit the state zones with halting business flight from certain highly distressed neighborhoods and providing the catalyst for new investment.[1] On a visit to the South Norwalk zone in Connecticut, Washington Post urban affairs writer Howard Kurtz noted that the zone incentives "have been remarkably successful in keeping more than a dozen existing firms from leaving town."[2] Chicago has enjoyed similar results. According to Patrick O'Grady of the Illinois Department of Commerce and Community Affairs, the Spiegel Corporation listed a zone designation in Chicago as one of the three reasons it decided to launch a $20 million renovation of its catalog sales facility in the neighborhood. Had it moved out of the area, as it was contemplating, almost 2,000 jobs would have been lost.[3]

The Sabre Foundation's state-by-state survey of the operational zones sought to identify jobs already created within the zones and jobs that had been "saved"--that is, cases where firms had planned to move or close but rescinded the decision after the zone was established. The survey discovered well over 7,000 jobs already created or saved by the enteprise zones now in existence, plus another 8,500 planned by zone companies. In addition, the state incentives were found to have been instrumental in securing commitments for $450 million in new construction, expansions, and renovations. Observes Robert Hawkins, Jr., chairman of the

---

1 USA Today, October 20, 1983.

2 Washington Post, November 6, 1983.

3 Enterprise Zone News, Vol. 2, No. 2 (Washington, D.C.: Sabre Foundation).

Advisory Commission on Intergovernmental Relations (ACIR) in the introduction to the survey results:

> The message of the data is clear: enterprise zones are delivering results....Enterprise zones in several of the states have been notably effective in reversing the decline of areas that until recently have been losing jobs by the thousands....Capital has flowed into such projects as manufacturing facilities, retail stores, office buildings and home construction and remodeling, much of it in neighborhoods once believed too decayed to recover.

The authors concede, of course, that some of the jobs would have been created without the zones. But they also point out that the enterprise zones are in depressed areas, where the normal birthrate of new firms is very low.[4]

The House of Representatives should note these figures carefully. They promise new jobs in some of the nation's most decayed areas. But while the states have taken the lead, there are limitations on the incentives they can provide. The enterprise zone concept requires a federal-state partnership. The states, in cooperation with cities and neighborhoods, design incentives compatible with the neighborhood, coordinate existing development programs, and experiment with innovative ideas. The federal government would not become involved directly in this development process, but would provide a package of tax incentives designed to establish a climate conducive to local initiative. The concept, in short, is in the spirit of the federal system: the federal government establishes the best environment for local development strategies, but does not coerce or determine those strategies.

So far only half of this partnership is in place. Cities and states have shown that they will take the lead, and they have designed successful zones. Still needed are the powerful investment and labor incentives in the federal legislation.

FISCAL IMPACT

The experience of the state zones strongly suggests that the fiscal impact analysis carried out by the U.S. Treasury is based on faulty assumptions leading to unwarranted, pessimistic conclusions.[5] Its authors have an unusual view of the nature of economic development in distressed urban areas. Examples:

---

4 Gerald Bonnetto and Dick Cowden, Enteprise Zone Activity in the States, (Washington, D.C.: Sabre Foundation).

5 Clifford Kern and Philip Spilberg, Enterprise Zone Incentive: Their Value to Firms and Their Cost to the Federal Government (Unpublished paper, U.S. Department of the Treasury, Washington, D.C., 1982). The Treasury figures are based on the Kern-Spilberg model.

1. New Firms vs. Relocations

Treasury Assumption: The Treasury analysis assumes that federal enterprise zone incentives will achieve a net expansion in employment of 10 percent each year. Of this, Treasury predicts that half would be due to relocations and half to new firms or expansions. Moreover, the analysis assumes "all activity generated by the programs would have existed somewhere else in its absence (i.e., the newly started or expanded firms, as well as those that have relocated, would have done business elsewhere had they not been diverted by enterprise zone incentives)." In other words, the Treasury assumes that the zone program will not create a single new job, but merely divert jobs to the inner cities. Hence all credits and incentives constitute a net revenue loss.

Reality: The Treasury assumes that zone tax incentives will not lead to net new activity--yet the same Treasury maintains that the Reagan tax incentives are generating new activity throughout the country (and the data support this). As elsewhere, incentives in the zones will create net new activity and this will mean new flows of income taxes, Social Security taxes, and corporate income taxes.

Relocation into the zone is likely to be more modest than Treasury assumes. Studies of firm location decisions show that companies put tax incentives well down the list of factors in choosing a site. Crime in the area, access to necessary labor skills, and similar factors are far more important--particularly for larger firms.[6] Companies simply do not pull up their roots and move to places like the South Bronx in order to obtain a few tax benefits.

The seminal work on urban job generation by David Birch also suggests that relocation will be low in the enterprise zones. Breaking down urban job creation by type of neighborhood, Birch showed that heavily minority central neighborhoods in declining cities (typical sites for enterprise zones) generally gain new jobs equal to about 7.7 percent of the existing jobs--although this is more than offset by losses of 9.6 percent. Almost two-thirds of new jobs come from startups. Only one-tenth are due to firms moving into the neighborhood from other parts of the city or from outside the metropolitan area. For this level to reach one-half by virtue of enterprise zone status, as the Treasury assumes, there would have to be a dramatic change in the normal job generation pattern. This is unlikely. Even in rapidly growing cities such as Houston, Birch shows, firms moving into the neighborhood are responsible for only one-eighth of the new jobs.[7]

---

6 See, for instance, Roger Schmenner, The Manufacturing Location Decision (Cambridge, Massachusetts: MIT Study, 1978); National Federation of Independent Business, NFIB Report on Small Business in America's Cities (Washington, D.C.: NFIB, 1981).

7 David Birch, Job Generation in Cities (Cambridge, Massachusetts: MIT Program on Neighborhood and Regional Change, 1980), pp. 16-17.

The Sabre Foundation survey also suggests that the Treasury has overestimated revenue losing relocations. "Almost none of the companies operating in the enterprise zones represent relocations," concludes the survey, "Major growth has come about from expansion of existing firms and from startups that otherwise appeared unlikely to occur." The survey notes that many city officials believe now that a significant proportion of the new projects either would not have occurred anywhere, were it not for the zones, or they would have taken place on a substantially reduced scale.

2. Utilization of Tax Credits

Treasury Assumption: The Treasury's fiscal impact analysis assumes that all existing firms in an enterprise zone, and all new firms, will be able to utilize the tax credits available in the legislation for hiring workers and investing in the zones. In the case of existing firms, in particular, this allows Treasury to deduce heavy revenue losses--even if there is only modest job generation.

Reality: This assumption is seriously flawed. Companies can only utilize the available tax credits if they have income tax liability against which to offset them. In depressed neighborhoods, many struggling firms have little or no tax liability, so the revenue loss on existing firms is likely to be much lower than the Treasury forecast.

Revenue loss due to startups also is likely to be lower than the Treasury calculates. The Sabre Foundation survey attributes nearly half of the zone activity to startups (in line with Birch's analysis of typical activity). But young firms, especially independent small businesses, generally have very low or zero income tax liability in their early years. So a significant proportion of the new firms in enterprise zones will not be able to use all the credits available to them. This will reduce the revenue loss.

3. Size of Typical Zone

Treasury Assumption: The Treasury bases its $1 billion price tag for 75 zones on what is described as a typical zone of 5 square miles, with 8,000 existing employees.

Reality: The Treasury's "typical" zone is probably much larger than the federal government would actually designate. The legislation calls for a minimum population (not workforce) of 4,000 in large cities, and only 1,000 in rural areas. The pending legislation sets aside one-third of all designations for small towns and rural areas. The size of the zones would have to be many times the minimum specifications to reach the Treasury's "typical" level of employment. The Department of Housing and Urban Development, which would be choosing zone sites, has made it clear that it envisions areas much smaller than the Treasury assumes.

4. Budget Savings and New Revenues

Treasury Assumption: In addition to its assumption that there will be no offsetting tax revenues generated by new firms and employees in the zones, the Treasury assumes no budget reductions due to savings on welfare and other costs effected by new zone employment.

Reality: The Treasury defends this unrealistic position by arguing that (a) since it assumes no new net activity will result, no new revenues will be generated, and (b) the study was not designed to analyze savings to the government.

These caveats may well have made the analyst's job easier, but they demonstrate the fundamental deficiencies of such cost estimates. To take a hypothetical example, if an unemployed man were to find a job in an enterprise zone, generate $1,000 in new corporate and personal income taxes, relieve the welfare rolls of $5,000 in outlays, and help his firm qualify for $3,000 in tax credits, the Treasury would put the cost of the job at $3,000. Budget reductions and new tax revenues amounting to $6,000 would be ignored.

The offsetting outlay reductions and new revenues are likely to be significant even though trying to estimate them would require the kind of controversial assumptions characterizing the Treasury analysis. But an approximate calculation based on the Treasury's "typical" zone indicates the range of savings and revenues that are being ignored.

If a zone has an employment base of 8,000 and, as the Treasury surmises, experiences a 10 percent annual net job growth, that would mean 800 new jobs each year. Assume all these jobs are net additions to the nation's employment level, and that all the new hires were structurally unemployed disadvantaged heads of two-parent households with one dependent child. Assume also that the workers are paid $5 per hour, or $10,000 a year.

In the state of Connecticut (which has designated 6 zones) this would imply a saving to the federal government of approximately $6,000 per year in Medicaid outlays, food stamps, and AFDC payments (available to two-parent families in Connecticut). At an income of $10,000, the employee would pay approximately $450 in federal income taxes and $650 in his share of Social Security taxes. If these savings and revenues were to be achieved for each of 800 new workers in 75 zones, the $1 billion annual "cost" to the Treasury of the enterprise zone program would be offset by $360 million in budget savings and $70 million in additional personal income tax. And this ignores additional corporate income tax and employer Social Security payments.

Clearly the above calculation takes an unrealistic best-case scenario, and so overestimates the positive impacts of the enterprise zone. But then, the Treasury analysis adopts an unrealistic worst-case. The accurate balance would no doubt be somewhere between the polar positions.

CONCLUSION

The enterprise zone initiative is a bold, bipartisan attempt to use state and federal incentives to spur economic development in the nation's most distressed communities. If Congress is looking for a program that guarantees results at a firm price tag, the enterprise zone is not that program. It is an experiment and should be seen as such. But the state data available suggest that it would pay off handsomely in new jobs for the hardcore unemployed. And the faulty assumptions of the Treasury's cost analysis point to a much lower revenue loss than some congressmen have feared. Good reasons for the House to move quickly and enact this long-overdue legislation.

Stuart M. Butler, Ph.D.
Director of Domestic Policy Studies