ENTERPRISE ZONES

AND

CENTRAL CITY

ECONOMIC REVITALIZATION

Submitted To
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TABLE OF CONTENTS

I INTRODUCTION

In this paper, I will discuss and evaluate legislation that would establish "enterprise zones" within distressed central cities as an effort to stimulate economic revitalization. Enterprise zone legislation, in various forms, has been under debate in the U.S. Congress since 1980, and is now on the agenda for the 98th Congress.

Businesses within enterprise zones would benefit from a variety of federal tax incentives and other concessions that are designed to reduce the cost of capital investment, and, in some cases, operating expenses and development costs.

Following a brief discussion of the history of enterprise zone concept, I will present a detailed analysis of how the various provisions of enterprise zone legislation can affect the investment decision-making process. I will then discuss the original theoretical development of this concept, and related policy issues in greater detail. I will conclude with a critique of the proposed enterprise zone program. This analysis will argue that the weaknesses of the enterprise zone approach stem from a failure to design the program in such a way as to accommodate the fundamental changes which have occured in the economy of this nation.

The enterprise zone approach has also been strongly criticized because it does not support the belief that economic development can be best achieved through the use of a comprehensive, planned economic strategy, which is based on community needs, strengths, and weaknesses. Other critics contend that the financial incentives of enterprise zones will prove to be insufficient in combating the plethora of physical and social disadvantages of central cities; especially when compared to the investment alternatives that are available within the suburban/exurban fringe.

Despite any merit these critisms may carry, President Reagan has chosen an enterprise zone approach as the basis of his urban economic recovery program.

Enterprise zones were first proposed by the Conservative Party in Great Britain. [(1)] The original legislative proposal called for setting aside a small area of the inner city as a capitalist "free fire" zone, without any taxes, regulations, or governmental interference beyond the provision of basic services and enforcement of minimal health and safety laws. However, opposition to complete regulatory defeasiance was too great. The bill that was finally adopted in 1979 called only for reductions in corporate income taxes.

The 1980 Urban Jobs and Enterprise Zone Act marked the first introduction of this concept in the U.S. This bill was sponsored by Representatives Kemp and Garcia and Senators Chafee and Baschwitz. Many alternative bills have been introduced since that time, but none have been adopted.

At issue in Congressional debate is the manner in which zone boundaries would be established, the number of zones allowed, and the merits and conditions of the financial incentives to be offered. The most current proposal by Representatives Kemp and Garcia would allow only 25 zones, 8 of which would be reserved for rural areas. (2) Zone designations would remain in effect for 20 years, with a four year phase-out period. The bill favored by President Reagan would establish 75 zones with provisions for a periodic assessment of changes in zone conditions (S 2298, 97th Congress).

The financial incentives offered by various enterprise zones vary, but, as in Great Britain, few have called for a significant relaxation of federal or local regulations.

This paper will primarily concentrate on the bills introduced by Representatives Kemp and Garcia, and President Reagan. Selected measures from other proposals will be presented for purposes of comparison and to highlight the policy differences of the various proposals under consideration by Congress.

Of all the issues surrounding this new approach to economic development, this paper will concentrate on the most important question: Will enterprise zones be successful in generating and sustaining economic activity? This analysis will, therefore, focus on those elements of the incentive package that are most likely to have an influence on investment and business development decisions.

Some of the "main stream" financial incentives offered by the various enterprise zone bills include: reductions in corporate and personal income tax rates; investment tax credits; accelerated depreciation allowances and recovery periods; elimination of the minimal tax on tax preference items; extension of the loss carry forward period; and tax credits for employers who hire unemployed zone residents. Some proposals would also require local governmental participation in the form of, for example, property tax abatements.

Most of these incentives are aimed at influencing the retention and growth of capital investment by reducing the cost of capital. Exactly how federal tax considerations affect the investment decision-making process is the next topic of discussion.

II TECHINICAL ANALYSIS

The purpose of this section is to evaluate the effect and significance of the financial incentives proposed by enterprise zone legislation. In order to better understand the significance of these incentives, it will be necessary to briefly explain the status of existing tax law as it relates to capital and real estate investment analysis. It will also be helpful to identify popular investment decision-making methods and criteria.

Most enterprise zone proposals have used federal tax concessions as the main enticement to attract potential zone investors. Changes in marginal income tax rates, provisions for the depreciation of capital investments, investment tax credits, and the treatment of long term capital gains can significantly alter the basic economic feasibility of an investment.

To the extent that firms locating or expanding within a zone benefit from a comparative tax advantage, there exists a justification to favor a zone location over other alternatives. However, for individual investment decisions, the final determination of whether or not an overall comparative advantage exists would depend on the total cost trade-offs involved in that particular investment choice. For example, the overall comparative development costs within a zone, due to such factors as the higher cost of assembling and purchasing a suitable parcel of land, may negate any comparative tax advantage.

Before entering this discussion, it should also be noted that most enterprise zone proposals would require that firms meet certain conditions before becoming eligible for the tax advantages. For example, the original draft of the Kemp-Garcia bill required that firms must derive at least half of their gross income from operations within the zone and that they employ a work force that includes at least 40% "CETA" (HR 292, 96th Congress) eligible workers. Other proposals link incentives to hiring zone residents. One bill, (HR 2965, 97th Congress) would require that businesses obtain "Job Expansion Business" status as defined by the Tax Act of 1954 to be eligible for federal tax incentives. A Job Expansion Business is defined by this tax law as a business with 50% or more of employee hours performed by employees who are substantially employed in the zone.

Such requirements have been at the center of congressional debate and have obvious policy implications. The concern of legislators is to not unduely restrict the attractiveness of tax incentives to prospective entrepreneurs. However, rules such as the requirement that the majority of gross income must be derived from operations originated within the zone could tend to deter larger corporations from simply relocating certain activities within zones. Such rules would thereby tend to favor smaller businesses that choose a zone location to initiate new production. Also, the requirement of hiring zone residents would obviously tend to ensure that employment benefits are targeted primarily to that group.

From this brief discussion, it is apparent that the orientation of the enterprise zone financial incentives, in terms of the size and type of firm most likely to gain from those incentives, is an important issue to be considered in the design legislative proposals.

Tax Rate:

One of the most commonly accepted investment decision equations is the "net present value rule". This rule states that the decision to invest depends on whether the expected future revenues generated by an investment, net of direct operating expenses and taxes, exceeds the price of capital: (3)

$$\text{Net Present Value} = C_0 + \frac{C_1}{1+r}$$

C_0 = Price of investment
r = Discount rate
C_1 = Net after tax cash flow

In this equation, future revenues are discounted to present values. If the present value of future revenues exceeds the cost of capital, the decision to invest would be justified on the basis that the net present value of the firm would be increased.

After tax net cash flow is calculated by subtracting operating expenses, debt service, and tax liabilities from gross operating revenues. The discount rate is based on opportunity cost of capital for the individual firm (i.e., the return that could be realized if resources were employed otherwise).

A reduction of the tax rate by 50%, as was originally proposed by the Kemp-Garcia bill, would increase after tax net cash flows and, hence, the resulting net present value of an investment. However, the magnitude of the benefit from this provision would be dependent on the

marginal tax rate of the investor. At the corporate tax rate of approximately 48%, or for an investor in the 50% tax bracket, the magnitude of benefit would be much greater than for an investor or small unincorporated business with a lower marginal tax liability. Also, for businesses without short term profits, such as a newly formed business that has not yet accrued sufficient revenues to cover start-up costs, such a reduction would be of no advantage during the early years of operations.

Depreciation:

The Economic Recovery Tax Act of 1981 made use of adjustments to allowances for more flexible use of depreciation as a cornerstone for the promotion of economic recovery. (4) Most enterprise zone bills would permit even more liberal use of depreciation by zone businesses. Tax depreciation is the method by which the cost of an asset is gradually written off (expensed) as that asset is losing its original value over the course of its useful life. (5) Depreciation is essentially a non-cash expense that is deducted from operating income for tax purposes, and therefore, it reduces the tax liability claimed against operating income. In some cases, the depreciation of real estate can actually produce a taxable loss which is then used to shelter other investor income.

The amount of depreciation that can be expensed each year is a function of the cost of the asset, its anticipated useful life, and the type of depreciation method used. Federal tax law governs the length of recovery periods that can be used, the extent to which depreciation can be accelerated and whether or not the asset can be depreciated below its salvage value. For example, the 1981 tax law permits real property asset values to be recovered over a 15 year period, while most machinery can be expensed within 5 years. (6) The original Kemp-Garcia enterprise zone bill would have allowed a straight line, three year depreciation of investments up to $500,000. This allowance would amount to a yearly write-off of $166,666 per year over three years, as opposed to a $100,000 yearly write-down if the asset would have normally fallen into a 5 year economic life category. A halving of the tax service life of equipment is estimated to reduce the cost of capital by 2.5 to 4 percent. (7)

Allowing the use of accelerated rates of depreciation can also improve investment returns. The advantage of using accelerated rates of depreciation, instead of a straight line method, is that a greater amount of the asset value is recovered during the early years of the project. Therefore, the present value of the total depreciation write-off is increased. Depreciation dollars claimed today have more value than those claimed at some later date. Federal tax law defines which rate of accelerated depreciation can be applied to the various types of assets. For example, according to the 1981 Tax Act, real property can be depreciated at 175 percent declining balance rate over a 15 year period. (8)

Several enterprise zone bills would permit a more liberal use of accelerated depreciation rates, such as the use of a 200 percent or double declining method. Using this method, the amount of depreciation allowed in any one year is twice the depreciable value of the asset divided by the depreciable life. (9)

Because depreciation is a non-cash expense and has no affect on before tax cash flow, it becomes a tax free cash distribution. The value of this tax shelter allowed by depreciation is equal to the tax rate multiplied by the depreciation allowance. Therefore, investors with greater tax liabilities stand to gain the most from more liberal depreciation allowances.

When depreciable assets are sold, the income from the sale is taxed at either a capital gains tax rate or at an ordinary (and higher) income tax rate. (10) The gain from a sale is measured by the difference between the price the owner received for the property and the price paid for it, less the amount of depreciation taken. Gain on the disposition of depreciable personal property is treated as ordinary income, rather than capital gain to the extent of all depreciation taken. For depreciable non-residential real property (if accelerated depreciation is used), all the gain on disposition is treated as ordinary income, while for residential real property, only the gain represented by the excess of accelerated depreciation over straight line would be treated as ordinary income. However, for both residential and non-residential real property, all gain is treated as capital gain, if straight line depreciation is used.

The current maximum capital gains tax rate for corporations is 20% (1981 Tax Act). The 1980 version of the Kemp-Garcia bill (HR 7563) called for a reduction of the rate to 15%, while their 1981 proposal (HR 3824) would have eliminated the capital gains tax entirely. Because of the differential treatment of residential and non-residential property described above, the elimination or reduction of the capital gains tax would prove more beneficial to returns from the sale of non-residential property.

As the capital gains tax applies to income from the sale of assets, it is difficult to assess the affect of its repeal on the economic behavior of firms.

A capital gains exemption will only produce an anticipatory benefit. Thus, this incentive would not result in a short term, measureable reduction in capital costs.

Property within areas likely to receive a zone designation will be priced at comparative depressed levels. Therefore, if enterprise zone measures are instituted and have a positive affect on economic conditions, land prices could rise dramatically. The anticipation of such results could be compounded by the prospect of a capital gains tax exemption. The speculative buying and selling of land could occur without a contribution to "real" economic activity or worth.

A capital gains exemption could also produce a bunching of asset sales in the period immediately before zone tax advantages are due to expire. This may lead to an altercation in business activity.

Tax Credits:

Several enterprise zone bills would offer additional tax credits for both investments in capital assets and for hiring "CETA" eligible workers. (11) A tax credit is usually taken as a first year "expensed" item, in the same manner as regular depreciation. (12) It is often referred to as a first year depreciation bonus.

Additional credits for the purchase of assets would be limited to personal property that is used in a trade or business. The 1982 Tax Act allows a write-off equal to 10% of the value of the asset and a total expensing of up to $5,000 of the cost of qualified property. Buildings or related structural components are not included as qualified property (except for the 25% credit allowed in the case of renovations to historic structures). One bill (HR 2965, 97th Congress), would permit a 5% credit for investments in new buildings and up to $400,000 of the cost of used property. These credits would be refundable up to $100,000, which means that a company could actually receive a tax refund if the deduction of tax credits and depreciation expenses produces a negative tax liability. Refundability is important to firms that, because of operating losses, would not otherwise be able to take full advantage of available tax credits.

The most recent version of the Kemp-Garcia bill has eliminated provisions allowing the refundability of tax credits (S 2298, 97th Congress).

The current tax law does permit firms to "sell" tax credits through a complicated sale and lease-back arrangement with another firm.[13] Still refundability would offer a more favorable option to smaller, newly-formed businesses. Making tax credits refundable would also eliminate the transaction costs involved in the sale of tax credits.

The Kemp-Garcia proposal also includes tax credits for workers employed within zones. This credit would result in a 5% reduction in the amount of income tax paid by workers. However, the effective wage increase resulting from this credit could be negated if wage scales are lowered by a corresponding amount to maintain parity with outside wages. Thus, this credit may actually operate to lower labor costs rather than to improve the lot of workers.

Additional tax deductions for employer contributions to employee

stock ownership plans (ESOP), would be permitted by HR 2965 (97th Congress). ESOP plans allow employees to gain an equity interest in their company. [14] The theory underlying this plan is that productivity gains will result from employees taking a keener interest in their work if they will receive an ownership interest in the company. This provision would probably result in greater benefits to both the company and its employees than would the employee tax credit described above.

Minimum Tax:

An add on minimum tax was enacted in 1969 to prevent tax payers from avoiding tax obligations through the generous use of write-offs, such as depreciation and tax credits. [15] The income from these "tax preference" items is taxed at a minimum rate of 15%.

The Kemp-Garcia bill would eliminate the minimum tax entirely. The elimination of this tax would compliment the value of increases called for in the form of tax credits and depreciation allowances.

Foreign Trade Zones:

The administration's proposal included a mandate that would create Foreign Trade Zones within enterprise zones. [16]

The statutory authority to create Foreign Trade Zones has existed since 1933. [17] Within these zones, the imposition of all duties and tariffs is delayed until the imported goods leave the zone for the domestic U.S. market, even if first used in manufacturing other goods. If the manufactured goods are re-exported from the zone, the duty on the imported goods is never levied. Foreign Trade Zones are, therefore, good locations for warehousing imports or for manufacturing operations based on imported raw materials.

Loss Carry Over:

Loss carry over provisions allow firms with operating losses in one year to carry over these losses and use them as deductions from net taxable income in suceeding years. [18]

The Kemp-Garcia bill included an extension of the loss carry over period from 15 to 20 years.

New businesses often suffer losses in their initial years, and it may be several more years before they have sufficient profits or tax liability against which to deduct operating losses or their available tax credits. Extending the carry over period and allowing the zone credits to be carried over will, therefore, reduce the risk of starting a new business. This is particularly true for small businesses which may not have outside income against which to deduct their losses, as larger firms usually have.

Small Business:

Several enterprise zone bills have aimed financial incentives directly at the needs of small businesses.

The original Kemp-Garcia bill would have permitted small firms to use a "cash basis" accounting system, rather than the accrual system. The accrual system requires the recognition of revenues at the time of sale, whereas with the cash system, revenues are not recorded until they are actually received. [19] Thus, the cash system allows income tax payments to be deferred until revenues are actually received. The cash basis system is also generally easier and less costly to maintain and does not need to be adjusted for bad debts.

Other changes designed specifically for small business include the relaxation of Subchapter S rules, special accelerated depreciation allowances and the expansion of Small Business Investment Corporation borrowing abilities (S 1240 and HR 2965, 97th Congress).

With Subchapter S status, a small business can obtain the advantage of single taxation at the shareholder level, while retaining the corporate feature of limited liability. [20] Within zones, "larger" small businesses could claim this privilege. The maximum number of shareholders permitted would be raised from 15 to 100.

Under the Small Business Investment Act of 1958, the federal government can purchase or guarantee 15 year debentures issued by SBIC's. [21] This authority is limited to a multiple of the paid in capital (equity) invested in the SBIC. SBIC's investing in zone ventures would be eligible for a higher debt capacity (debt to equity ratio), which would increase their leveraging ability. This measure could potentially expand the total amount of venture capital available to zone enterprises.

Minimum Wage:

President Reagan has advocated that employers within enterprise zones be exempt from minimum wage levels. [22] Theoretically, this would permit the employment of workers who's productive worth does not exceed the minimum wage, and would thereby help to eliminate "chronic" unemployment. (In addition to the many obvious faults with this justification for the elimination of the minimum wage within zones, this proposal has received strong opposition from labor leaders who fear a weakening of their bargaining power would result from any attempt to lower wage levels within zones.)

Addendums:

The Kemp-Garcia enterprise zone proposal was amended near the close of the 98th Congress to include the following measures: (23)

The interest income from loans to zone businesses would also be eligible for the 50% reduction in income taxes, and, special enterprise zone development companies would be given the ability to write-off the cost of stock purchased from zone businesses. The addition of these measures reflects the desire to stimulate the formation of venture capital within zones, rather than to only reduce the cost of capital through investment credits.

The scope of zone incentives was also broadened to include housing investment incentives.

Local Incentives

Several bills would require that local governments enter into contracts stating explicitly how they will reduce burdens on employers.

The Kemp-Garcia proposal would require that property taxes be lowered by 20% over a four year period. Property taxes often constitute one of the single largest operating expenses of commercial property and can thus significantly affect the return on equity invested in real estate. (24) Property tax rates are also often cited as having a strong influence on business location decisions.

Other local measures could include improvements in services or the streamlining of local regulations; such as the relaxation of zoning or building restrictions and permit procedures. Service improvements could range from upgrading public facilities to improved police and fire protection.

Potential longer term negative implications exist with the relaxation of zoning and building standards. However, the addition of more administrative flexibility and efficiency to local ordinances may effectively reduce development costs.

Contributions by local governments to the enterprise zone effort would compliment the affect of federal tax incentives. Local efforts could direct greater attention to issues related to the quality of life factors that influence business location decisions.

State Attempts:

Ten states have enacted some form of enterprise zone program. (25) State programs all rely on tax relief; five call for targeted deregulation and four for improved local services.

Venture capital is provided in the form of a one million fund in Connecticut and access to a loan guarantee fund has been established in Maryland. Kentucky's program calls for the development of neighborhood enterprise associations.

A report by the National Conference of State Legislatures has generally questioned the sufficiency of targeted reductions in taxes and regulations in attracting new business; especially, in the ten states that have adopted programs because none have particularly high taxes to begin with. (26) Tax exemptions are more powerful if taxes before the exemption are relatively high. In such areas, the report doubts the success of state zones without an augmenting federal designation.

The report also argues that the use of neighborhood organizations and private firms to provide public services is unproven. It challenges the value of reducing zoning laws, building codes, usuary laws and other state rules which have been identified by the Reagan Administration as impediments to business development.

The study cites the use of venture capital and loan guarantees as important considerations, but that those state programs thus far initiated have made only token efforts in that direction. It was added that the existing direct financing mechanisms such as tax increment and industrial revenue bonds are unlikely to benefit small firms. The report concluded that more innovative efforts are needed such as revolving loan funds, and the use of state set-asides for job training.

The tax incentives proposed by the various federal enterprise zone programs are primarily designed to stimulate economic development by reducing the cost of capital. The underlying assumption here is that the cost of capital is the controling factor in the decision to invest in private productive capital.

As stated earlier, in the case of central cities, this assumption must be altered if we take into account the deliterious social and physical environment that faces prospective investments in central cities. In a case-by-case analysis it is very likely that such negative environmental conditions would make the information contained in an abstract investment equation totally irrelevant.

Some economists contend that it is the rate of capacity utilization (i.e., level of production and demand) that is the dominant determinant of the rate of investment by businesses.[27] Generally speaking, this line of thinking has had a predominant influence over public policy since the Great Depression.

However, other factors, such as inflation, foreign competition, and resource supply uncertainty, have added vast complications to what was once seen through Kanesian eyes as a simple trade-off between inflation and unemployment.

If it is in fact the rate of capacity utilization that is the primary influence over aggregate capital investment, the use of enterprise zones would at best result in shifting the geographic location of economic activity. Enterprise zones would not, therefore, significantly affect the overall level of capital investment.

What then is the "localized" sensitivity of capital investment rates to tax incentives and the other cost reducing measures that would be implanted within zones? This line of thinking returns us to the generally disadvantaged position of central cities. Central cities must still compete with suburban areas which can claim both a far better set of social and physical environmental amenities, and the space to accommodate the needs of modern production facilities.

The Economic Recovery Tax Act of 1981 instituted substantial tax cuts for capital investment. In the face of mounting deficits, about half of these tax cuts were repealed in 1982. However, the effective tax rate on corporate income remains quite low, according to a recent Urban Institute report (Hulten, Robertson, 1982). This report estimated that the "effective rate" on corporate income was about 33% in 1980. Under the 1981 Tax Act it would have actually fallen to a negative value by 1986. Now, under the amended act, the effective tax rate will fall to 15.8% (assuming a 6% yearly inflation rate). This effective rate is still less than half the rate in 1980.

The administration's enterprise zone incentive package is claimed to eliminate 75% of the corporate income tax. However, the true magnitude of the tax incentives must be evaluated relative to the existing rate, which has already been significantly reduced for all corporations by the existing tax law. Seventy-five percent of the 15.8% rate would amount to only an 11.8% reduction in the corporate tax rate.

III POLICY ANALYSIS

I would like to preface the following policy evaluation of enterprise zones with a list of facts related to economic and employment trends within central cities. The following list is taken from the conclusions of the 1980 President's National Urban Policy Report: [28]

1. Twenty-three major central cities lost employment during the 1970's.
2. Cities that have gained employment have gained five times as many jobs in trade and selected service sectors as they did in manufacturing.
3. Net in-migration is not a major source of jobs in any region. The most significant factor in regional difference of new job formation is the difference in the rate of new firm formation.
4. Manufacturing employment is declining in almost 2/3 rds of the large central cities of the nation with populations in excess of 250,000.
5. Since 1950 almost all net national employment growth has occurred in service, trade, finance and governments. "White collar" jobs now comprise about half of all national employment.
6. Young small business establishment, during their first four years, produce nearly four of every five new urban jobs.

7. Shortages in equity financing is a particularly great problem for small businesses. (Large firms can sell stock and retain earnings. Also, long term debt tends to be more costly for small businesses because of the risk aversion of lenders and their orientation to serving larger firms.

8. Local governments' attitude toward business (service provision, regulation and taxation) has been cited more frequently than any other factor by businessmen asked about factors affecting their locational choices.

Peter Hall is one of several people who have been credited with originating the enterprise zone concept. He provided much of the urban policy analysis behind the adoption of enterprise zone legislation in Britain.

According to Hall, one of the key causes of the economic crisis has been the mismatch between the skills and educational capacities of inner city residents and the requirements of newer and more technologically oriented modes of production. (29) In the U.S., this problem is compounded by the higher cost of labor relative to other developing nations. This gives them a much greater competitive advantage in low skilled, labor intensive goods production.

Taiwan, Korea, Hong Kong and Singapore have all experienced outstanding levels of growth and low unemployment during the same period that the U.S. has floundered through periodic recessions. Hall concludes that it is our high level of regulation and taxation, combined with higher labor costs, that have created a business environment that impedes sustained growth.

It is in this context of thought that Hall conceived of urban islands with complete freedom from taxation, regulation and an open labor market in which the price of labor would meet its demand. While he recognizes that lower wages would be contrary to progressive social ideals, he argues that a low wage is better than no wage. Eventually, he reasons, firms and labor within zones would move up the learning curve until wages and skill levels more closely equaled the norm.

Most importantly, Hall claims that the "spill over" affect of zones will help to revive the broader economy, which will allow older developed nations to sustain a more competitive position in the world market. This last objective stresses the urgency of adopting an enterprise zone approach.

Most legislative proposals for enterprise zones have called for reduced taxation, although few have included significant regulatory relief. Except for President Reagan's desire to relinquish minimum wage levels, none have contained measures that would restrict wages within zones.

The merit of adding greater regulatory relief to an enterprise zone program is questionable. A consistent system of building and land controls adds a level of certainty to the business development environment. Without controls and with greater uncertainty, financial institutions may be reticent to support development within zones if they cannot fortell the character of surrounding development. The absence of building standards could reduce the future marketability of buildings located within enterprise zones.

Enterprise Zones vs. Planning Theory:

With its roots in a conservative philosophy of public policy, the enterprise zone approach poses a strong contrast to the theories of economic development championed by the planning profession.

The planned strategy approach to economic development usually relies on an attempt to assess the unique strengths of the community and then prescribes a goal-oriented process of achieving the desired form of new development. The strategy approach is thus much more directed and specific as to the types of new industries best suited to the needs of the community. A good example of a planned economic strategy is contained in a report recently completed for the City of San Antonio, Texas.[30] This study identified specific industries that offer the best long term growth prospects and that complimented the unique local resources of San Antonio. It also mapped specific steps aimed at promoting those industries, such as the establishment of a school of engineering at the local state university.

Since the enterprise zone approach is not "fine tuned" to any particular industry group or community, its contribution to a local economic development strategy would be fortuitous.

President Reagan has stated that programs such as the Urban Development Action Grant and enterprise zones are designed to compliment rather than displace market decision making processes.[31] He criticizes other "targeted" programs as channeling money to less competitive firms. Presumably, these comments relate to the danger that governmental subsidy programs actually operate to sustain firms that would otherwise fail.

The distinction drawn by President Reagan's comments is not valid for several reasons. In the case of enterprise zones, alterations of the tax affect on investments decisions could significantly change the final distribution of resources.

The financial incentives offered by enterprise zones will be targeted geographically, and any eligible firm within the zone can benefit from those incentives. This indescriminate approach does not preclude the possibility of assisting uncompetitive firms. In fact, it could be argued that greater discretion than what is offered by the enterprise zone approach would safeguard against the subsidy of firms that do not merit assistance.

A recent study by the U.S. General Accounting Office reached a number of discouraging conclusions with regard to the likely success of enterprise zones. (32) In reaching these conclusions, the report cites the past poor response of businesses to tax incentives (especially credits for hiring the disadvantaged), and the general doubt that mere tax benefits can overcome the plethora of problems that plague central cities. It also calls attention to the danger that capital gains exemptions and investment credits could end up attracting firms that fail to create new jobs. Even if successful, areas surrounding the zone could be put at a competitive disadvantage. Relocating firms would shuffle jobs around without creating new employment. The report also warns that escalating land values could actually force out unemployed residents.

Despite these warnings, linking zone incentives to the requirements of reporting and compliance standards has been rejected by presidential advisors on the basis that such requirements would amount to unnecessary federal prescriptiveness. (33)

Economic Trends and Business Location Factors:

Several recent surveys have supported the claim that "quality of life" and general business climate factors can strongly influence business location decisions. [34] These factors include many considerations that are not directly translated into immediate development or longer term operating costs. Many cities may not offer satisfactory locations for new business, regardless of the magnitude of financial incentives that can be harnessed via federal or local tax concessions.

In the conculsions of the 1980 Presidential Urban Policy Report, it was revealed that the majority of employment growth within central cities during the 1970's came from the expansion of existing businesses; and that relocating industries were not a major source of new jobs. It was also found that young small businesses account for a disproportionate share of added employment opportunities. Together, these facts indicate that a program aimed at "chasing" industries may not be effective. Instead, efforts to foster the growth of existing local industries, especially smaller growth industries, may have much better long term results.

Another consideration in terms of achieving economic development objectives should be the transitional nature of the national economy. The decline of manufacturing industries in this country has been accompanied by an increasing importance of the service sector, which now accounts for more employment than any other sector of the economy (Exhibit I). [35] Accordingly, economic theorists have begun to reevaluate the role of the service sector in terms of its contribution to the GNP.

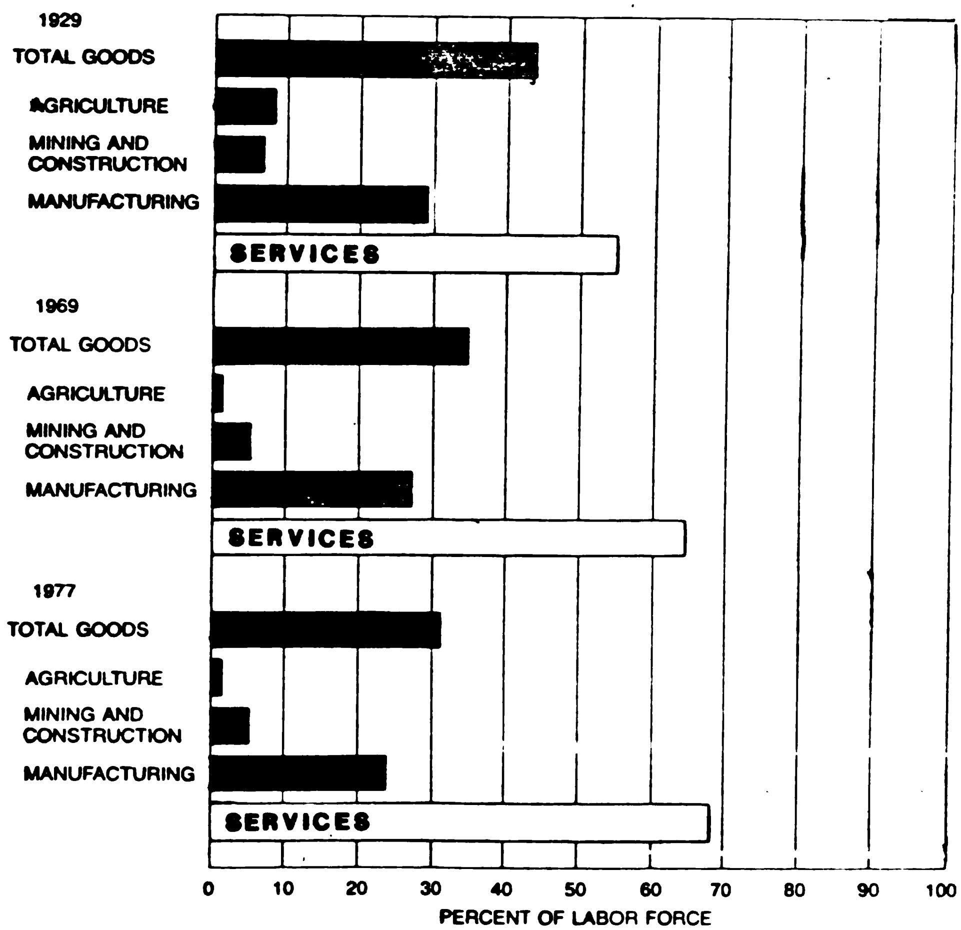
The growth trend of service industries has challenged the traditional economic theory that only the basic resource extraction and manufacturing industries can contribute to the creation of wealth. The human capital component of economic activity is now gaining greater credence. For example, as other countries develop greater productive and technological capabilities, they will rely less on U.S. manufactured capital equipment. However, such things as professional legal, construction and business management expertise may still be drawn from the U.S.

The rise of the service sector has resulted in a tremendous increase in the amount of office building space within downtown areas. Almost all major cities have experienced dramatic increases in office space throughout the 1970's and into the early 1980's (Table II). [36]

Despite the changing role and importance of the service sector, it is premature to discount the value of basic manufacturing industries. However, the future potential of manufacturing industries in terms of generating new employment is simply not as great as it once was. Further, programs such as the enterprise zone, which attempt to reindustrialize the economy through heavy investment in plant and equipment, may be misdirected because of these conditions. The policy issues and economic trends discussed above point to better alternatives.

I will now outline what appear to be the major strengths and weaknesses of the enterprise zone approach. I will conclude by suggesting those zone provisions that should be eliminated or given more puissance, and by suggesting a more limited and experimental role for this new and controversial economic development program.

EXHIBIT I



Source: "The Service Sector of the Economy," Scientific American, March, 1982

TABLE I

OFFICE SPACE EXPANSION IN CORE AREAS OF SELECTED CITIES: 1970–1978

(Data are millions of square feet)

City	Office Space 1970	Office Space 1978	Percentage Increase
Atlanta	10.8	16.9	56.5%
Baltimore	8.0	10.0	25.0
Boston	28.5	38.0	33.3
Chicago	57.8	77.8	34.6
Cincinnati	10.1	10.5	4.0
Cleveland	16.5	18.7	13.3
Dallas	18.0	20.4	36.0
Denver	7.8	15.8	102.6
Detroit	11.5	18.0	56.5
Houston	13.9	22.2	59.7
Indianapolis	10.4	12.4	19.2
Los Angeles	38.0	45.0	36.4
Milwaukee	9.0	11.5	28.0
Minneapolis	10.0	14.8	48.0
Newark	2.8	4.6	64.3
New Orleans	5.5	8.5	54.5
Philadelphia	24.1	32.2	33.6
Pittsburgh	8.7	13.2	51.7
San Francisco	25.0	35.0	40.0
Seattle	4.5	7.2	60.0
Average Percentage Increase			42.9

Source: 1980 President's National Urban Policy Report

IV CONCLUSION

To this point, I have raised many issues associated with the enterprise zone concept: the role its financial incentives can pay in the investment decision making process; as well as the broader issues of how this approach compares to alternative economic policies which focus on a more individualized strategy that is geared to local needs and conditions.

Generally speaking, the enterprise zone concept is a kind of "supply side" approach to urban economic development. The theory of enterprise zones is rooted in a conservative belief that tax reductions will automatically spur economic activity and thus provide the seed for a revival that will initially provide an earned income for the poor and, in course, new tax revenues to pay for urban infrastructural improvements. This scenario assumes that other social problems will eventually dissolve in the wake of a new prosperity.

To the above, we can add the hope of economist, Peter Hall, that the innovation spawned within zones will overflow to the balance of the urban economic network and engender a revival of the national economy.

However, a closer examination of enterprise zone proposals has brought out a large number of weaknesses that could jeopardize its success as the basis of an urban economic policy. These weaknesses can be summarized as follows:

1. An enterprise zone program will not directly address the broader spectrum of physical and social deficiencies that pose a major and immediate impediment to the revival of economically distressed communities. Supporting this claim

is the evidence which proves the importance of quality of life issues in business location decisions.

2. The enterprise zone approach fails to incorporate or facilitate local planning efforts which can be aimed at promoting the unique resources and attributes of the local community. Without the support of a consciously planned local effort, enterprise zones will not be fully capable of fostering the growth of industries with special long term growth potential. The technical analysis of this paper has revealed that there is a certain inherent bias of the financial incentives toward larger and more capital intensive industries. Such industries may not be suited to community needs, or may not offer long term growth potential because of the transitional conditions of the national economy, which indicate greater potentials in other sectors.
3. In view of the bias toward larger industries, and the evidence that small businesses account for a disproportionate share of new jobs, most enterprise zone legislation has failed to adequately prioritize the range and magnitude of financial incentives offered to this segment of the economy.
4. Enterprise zone financial incentives have also not been adequately tailored to meet the needs of other high growth sectors of the economy; such as the service and information based industries, and more highly technologically oriented manufacturing industries.

In general, enterprise zones rely far too much on simple tax incentives that are most attractive to investment in plant and equipment, primarily for the traditional heavy manufacturing industries.

5. Zone financial incentives are not adequately conditioned by the requirement of hiring zone residents. To be truly successful in attaining their central goal, enterprise zones should be designed to incorporate or collaborate with a large scale retraining effort.

6. Enterprise zones have not included sufficient safeguards against the danger that businesses will merely relocate to zones and thus draw employment away from adjacent areas, without creating any "real" new employment.

Because of these many weaknesses, the use of enterprise zones should be limited to an action of last resort, to be used in only a few of the most severely distressed areas where the feasibility of other development efforts is extremely limited in the near term. In this more limited role, enterprise zones have the following advantages over other economic development programs:

1. Little "front end" work is needed for its implementation, thus results could be achieved much faster.

2. Since most financial incentives would be instituted via the federal tax system, this approach dispenses with the need and cost of federal and local intermediaries to administer the program.

3. Other implementation cost savings would result from lower program auditing and monitoring costs. Aside from the

existing accountability standards already in place through the Internal Revenue Service, only simple base line studies would be required to monitor economic changes within zones.

If enterprise zones are found to be unexpectly successful when used on a limited "trial" basis, they could then be used more extensively, but concert with existing federal programs, and locally initiated economic development strategies.

I would like to conclude this paper by making one final suggestion with regard to the type of financial incentives offered by enterprise zones. Special incentives which are offered exclusively to smaller, growth oriented firms should be strengthened and expanded. Additional incentives should be designed to meet the special venture capital needs of small businesses. Such measures should include special incentives linked to the sale of stock in small business investment corporations that operate within zones; additional small business loan guarantees; and a liberalization of controls on the investment options of banks and pension funds to allow them to take a greater equity interest in newly forming industries within zones. Also, the investment tax credit provisions of enterprise zones should be amended to include special write-offs for investments in smaller companies.

A singular reliance on financial incentives which tend to benefit primarily larger, established industries will tend to cause a relocation or expansion of firms within zones, without an overall net increase in the number of new jobs.

As a further safeguard against the danger that zones will merely become safe havens for larger firms, eligible businesses should be required to have a majority of their assets located within the zone.

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