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Enterprise Zones

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Before the
Committee on Ways and Means
House of Representatives

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Mr. Chairman and Members of the Committee:

I am very pleased to be here today to discuss GAO's work on enterprise zones. Specifically, Mr. Chairman, you asked us to address the objectives of enterprise zone programs and experience with existing enterprise zone programs. My testimony today is based on the congressionally requested study we reported on in December 1988.[1]

OVERVIEW OF GAO'S ENTERPRISE ZONE STUDY

In September 1986, with interest in the British concept of enterprise zones rising in the Congress, GAO was asked to study possible offsets to the cost estimates made by the Treasury Department of a proposed federal enterprise zone program. GAO was also asked to determine whether there were lessons to be drawn from current state experience with enterprise zones that could be applied to the new federal program. Specifically, the GAO study addressed the following questions.

1. What assumptions do federal departments, particularly the departments of the Treasury and Housing and Urban Development, make about the potential performance of a federal enterprise zone program? Specifically, do they assume that such a program would create revenues through new

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[1] See Enterprise Zones: Lessons From the Maryland Experience, GAO/PEMD-89-2 (Washington, D.C.: December 15, 1988).

job creation and possible reductions in welfare dependence that could offset the costs of creating the program?

2. How much has employment grown within state-designated enterprise zones, especially in the programs that most closely approximate the types of tax incentives contained in proposed federal enterprise zone programs?

3. What offsetting revenues have been realized as a result of decreases in federal transfer payments to workers employed by participating businesses within state-designated enterprise zones?

4. Has welfare dependence declined among workers employed by businesses participating in state-designated enterprise zones?

5. What federal lessons can be drawn from state experiences with enterprise zones about the relative effectiveness of different tax incentives and other local business development strategies?

To answer these questions, we analyzed a then-pending federal enterprise zone bill, H. R. 3232, in the 99th Congress, and data from the existing Maryland enterprise zone program, which we selected because of its similarity to H. R. 3232.[2] We

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[2] The bill and the Maryland program are compared in appendix I.

identified theoretically possible offsets to the cost of a federal enterprise zone program that were not included in the cost estimates prepared by the Department of the Treasury. These offsets depended on the program's success in achieving net job creation in the enterprise zones. In our empirical analysis of the Maryland program, however, we could not show any employment growth that was demonstrably attributable to the enterprise zone incentives. Therefore, although these offsets are theoretically possible we could not confirm them empirically. We found neither offsets to program costs nor reduction in welfare dependence among enterprise zone workers. Also, we found that the tax incentives and other inducements typically offered by government to encourage economic development were not seen by firms as especially important factors in their location decisions. However, we did identify some enterprise zone incentives that appeared to be more important than others to firms' hiring and investment decisions.

The subject of today's hearing, H. R. 6, when considered in conjunction with the Housing and Community Development Act of 1987 (Public Law 100-242), is substantially identical to H. R. 3232. This means that our study is as applicable to the current proposal as it was to H. R. 3232.

In the remainder of this statement, I will discuss the objectives of enterprise zone programs and describe, in more detail, our analysis of the Maryland enterprise zone program, focusing on employment growth and the responsiveness of firms to the enterprise zone incentives.

ENTERPRISE ZONE PROGRAM OBJECTIVES

Enterprise zones are economically distressed areas designated for preferential governmental treatment to promote investment and job creation by private industry. As originally implemented in the United Kingdom in the early 1980s, these programs were intended to encourage industrial and commercial activity by promoting the development of vacant or damaged land. In the United States, proposed and actual enterprise zone programs typically have had two objectives: the revitalization of depressed urban or rural areas and the creation of jobs.

The philosophy behind the enterprise zone concept is that reducing governmental burdens on industry (for example, taxes and "red tape") in targeted areas encourages private investment and growth there. By removing the burdens associated with taxes and the requirements of federal, state, and local regulations, government could, for example, compensate for costs incurred when firms locate or operate in areas with high crime rates or an untrained labor force. Thus, according to this rationale, removing costs--or compensating for them--could be a powerful incentive to firms in making location decisions, and an enterprise zone program would therefore increase the attractiveness of depressed areas to businesses.

For our study, we were asked, first, to identify the assumptions that federal departments have made about the potential performance of an enterprise zone program in terms of the likelihood that the program's costs could be offset through job creation and reductions in welfare dependence. We found that the Department of the Treasury, in an unpublished manuscript, made the assumption that an enterprise zone program would yield no offsets to costs over the first 6 years of operation. This is based on Treasury's view that in the short term, a successful enterprise zone program could, at best, redistribute to enterprise zone areas economic activity that would have occurred elsewhere; at worst, such a redistribution could induce businesses to relocate from more efficient to less efficient areas and, thus, actually reduce national product.

We raised an alternative perspective on the possible performance of enterprise zones, suggesting that program-related increases in enterprise zone employment could, under certain circumstances, lead to an expansion of national output and employment without an associated increase in inflation. This favorable result could occur if the program succeeded in shifting employment from an area with a tight labor market, where a further expansion in the demand for labor would drive wages up without creating much added employment and output, to an area with a labor surplus, where an increase in demand would translate into new jobs and output without an equivalent inflationary effect on wages. To the extent that such location shifts in employment were achieved, the use of enterprise zones could, for a given growth rate in aggregate demand, increase national employment while reducing inflationary pressures in the economy. This suggests the view that an enterprise zone program is one means of correcting a market imperfection--namely, barriers to labor mobility.

Validating either of these perspectives must begin with data showing that enterprise zone programs bring about increased employment. If no such increase can be demonstrated, then no offset can be expected, no matter which perspective is right. Since this is an empirical issue, we began our study by addressing it.

EMPLOYMENT GROWTH ANALYSIS

Our second evaluation question thus concerned the extent of employment growth within the enterprise zones. To address it, we analyzed three Maryland enterprise zones. As already noted, we selected the Maryland program because of its similarity to H. R. 3232; however, another factor in its selection was that by 1987 the program had been in operation at all the sites we studied for almost 4 years, allowing time for program effects to be measurable.

The three Maryland enterprise zone programs had been implemented between December 1982 and December 1983. For all three zones, we analyzed monthly employment data on participating firms for April 1980 through September 1987. Our analyses were designed to detect both abrupt and gradual changes in employment levels following the implementation date of the program at each site, relative to employment patterns prior to implementation.

We found that total employment among employers participating in each enterprise zone did increase by between 8 percent and 76 percent after implementation. What remained was to tie these employment increases to the enterprise zone program. Establishing a causal relationship between the program and the employment changes means being able to show that the changes were unlikely to have occurred in the absence of the program.

To address this issue, we conducted statistical analyses of the employment trend data from the three sites. In two cases we found some initial evidence of possible program effects on employment. In both these instances, we contacted officials of the firms responsible for the apparent employment increases to determine whether they had relocated into an enterprise zone, or increased employment at an existing facility in such a zone, in response to the enterprise zone incentives. However, in no case did these firms cite the enterprise zone incentives as the reason for their location or employment decisions. Several employers cited increased demand for their products as the major factor in their decisions to hire additional workers. Two others began participation in the program too late for it to have been a factor in their decisions. (Indeed, one firm reported learning of the program only after locating in the zone and beginning its hiring actions.)[3]

Overall, we could not attribute the observed employment increases at these three sites to the Maryland enterprise zone program. Based on this finding, the answer to our third question is that the program was not likely to have generated cost-offsetting revenues. Similarly, the answer to our fourth question is that the program was unlikely to have reduced welfare dependence among workers in the zone areas. If there were increases in revenues or reductions in welfare dependence, they would not appear to be attributable to the program.

RELATIVE IMPORTANCE OF VARIOUS INCENTIVES

Our fifth question looks behind enterprise zones to the relative effectiveness of different tax incentives and other local business development strategies. To assess the possible

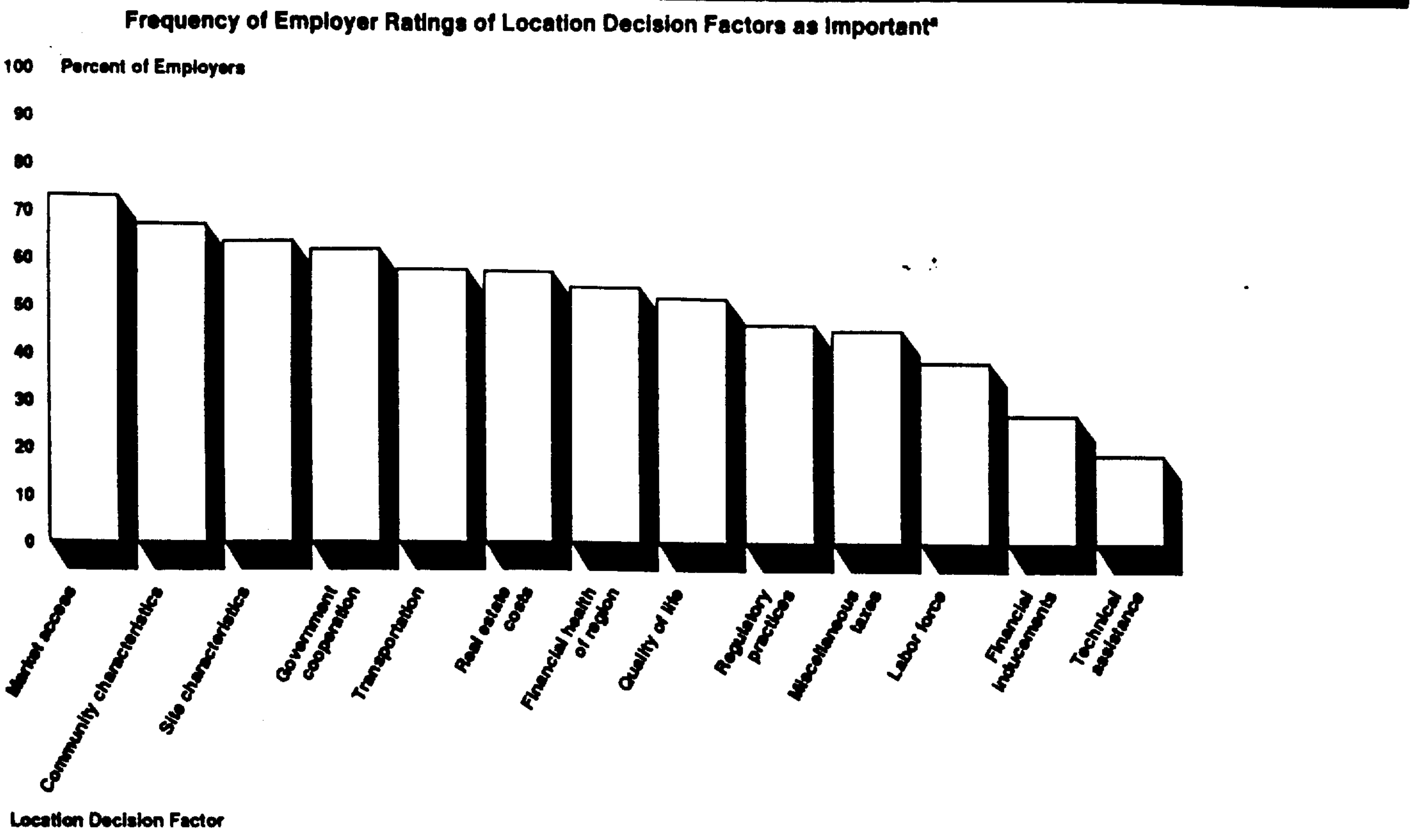
[3] Details of our analyses are in appendix II.

effectiveness of these, we conducted a mail survey of employers in four Maryland enterprise zones and in one area that did not have an enterprise zone. We questioned the employers on the importance of an enterprise zone program and other development strategies in their business decisions.

Our survey indicated that the kinds of factors that are generally available for either the states or the federal government to offer as incentives to business firms were low on the list of factors that firms considered important in making their location decisions. Figure 1 shows that regulatory practices, taxes, and financial inducements (such as grants, special interest rates, and subsidies) ranked lower than such factors as market access and community and site characteristics as influences on location decisions. This finding is consistent with other studies in the economic development literature.

However, the employers we surveyed reported that although financial inducements are not strong incentives for <u>location</u> decisions, they may influence <u>hiring and investment</u> decisions. Respondents from Maryland firms participating in the enterprise zone program rated most features of the program important. Figure 2 shows that 87 percent of participating employers rated the property tax incentive important. However, the "new hire" credit (up to $500 for each new job) and the credit for hiring the disadvantaged (up to $3,000 over 3 years for each new job),

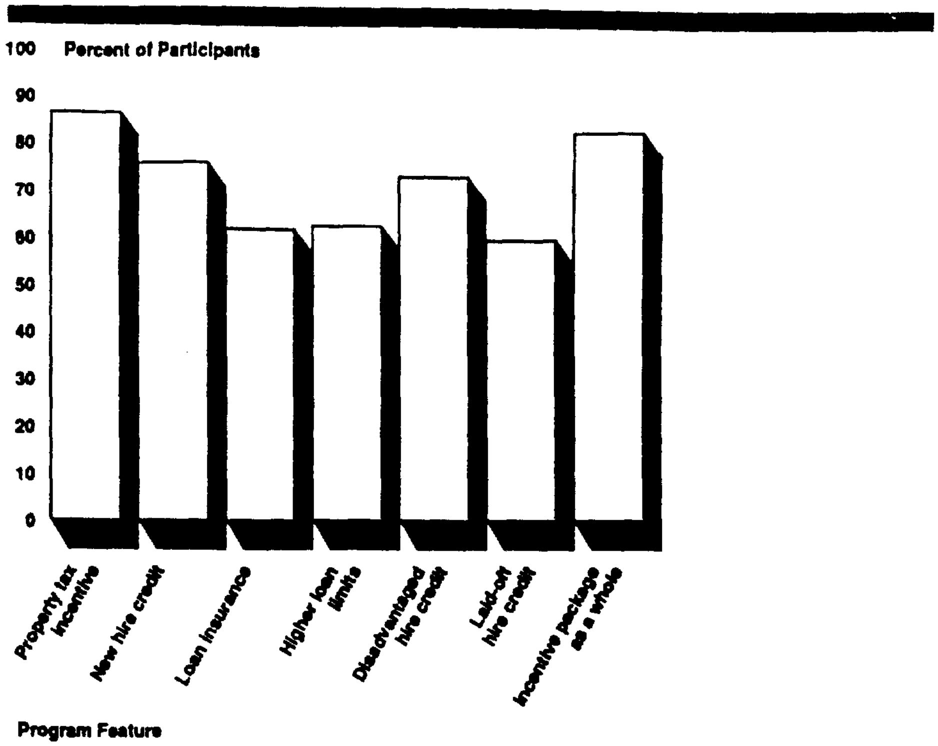
Figure 1:



[a] "Important" is defined by an employer rating of moderate, great, or very great importance on a 5-point index.

Figure 2:

Frequency of Program Participant Ratings of Maryland EZ Program Features as Important[a]



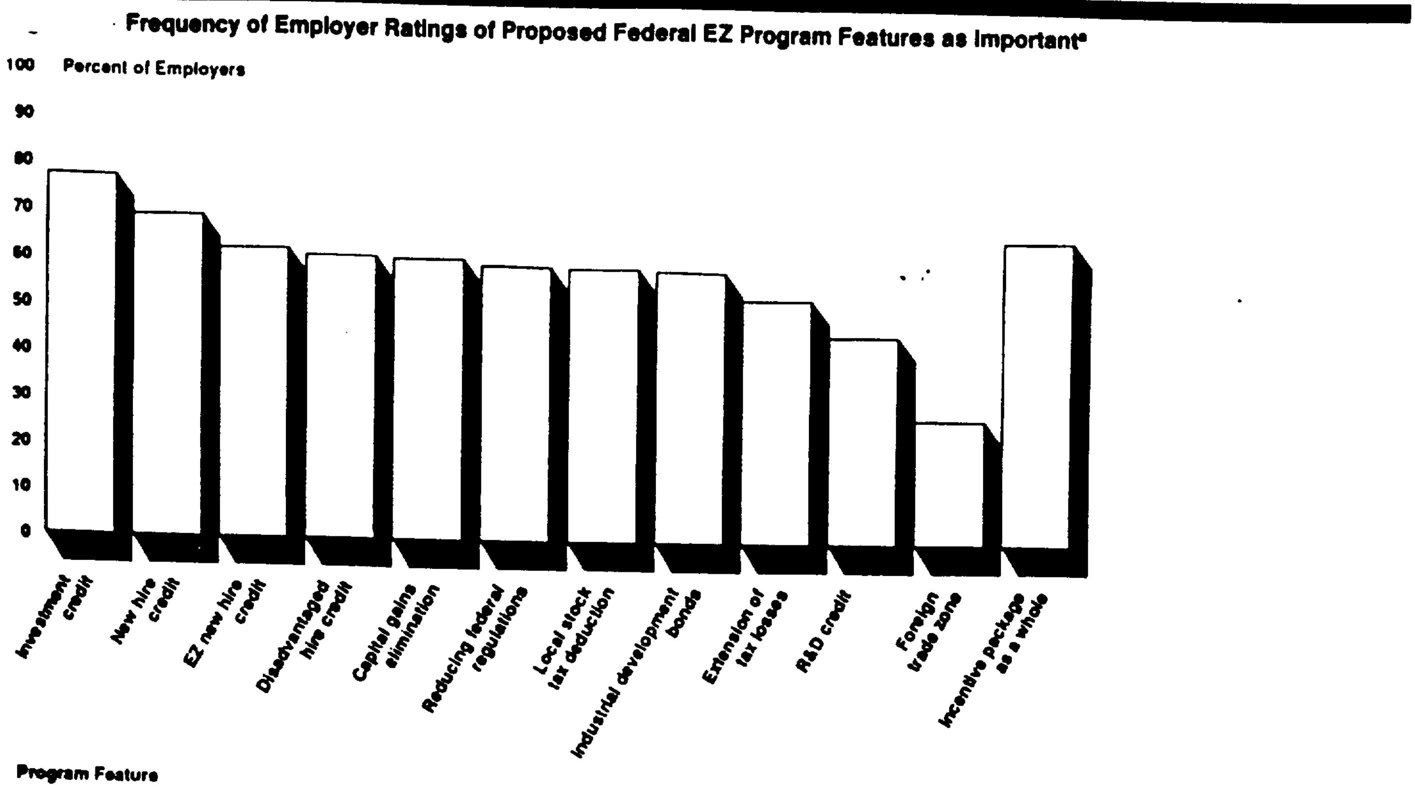
[a]"Important" is defined by an employer rating of moderate, great, or very great importnace on a 5-point index.

both similar to provisions of H. R. 3232 and H. R. 6, were also seen as important considerations in hiring decisions by about 3 out of every 4 responding participant employers.

A final section of our survey asked our full sample of employers to rank the importance of incentives similar to those specified in H. R. 3232. Figure 3 shows that most of the incentives were judged important by the majority of the employers. The investment tax credit and the federal income tax credit for new hires had many high ratings: 77 percent of the respondents rated the investment credit moderate, great, or very great in importance; 70 percent rated the new hire credit of at least moderate importance.

Five other incentives had lower and roughly equivalent ratings: the disadvantaged hire credit, nonrecognition of capital gains, reduction in federal regulations, enterprise zone stock tax deduction, and the availability of industrial development bonds. Each of these incentives was rated of at least moderate importance by between 59 and 62 percent of the respondents. The federal incentive package as a whole was rated relatively high: 66 percent of the respondents rated the package moderate, great, or very great in importance in influencing investment and hiring decisions. In short, employers apparently viewed some proposed federal tax incentives as potentially influential in their business decision-making.

Figure 3:



[a]"Important" is defined by an employer rating of moderate, great, or very great importance on a 5-point index.

CONCLUSIONS

In conclusion, GAO found that an enterprise zone program could theoretically lead to a net increase in national product by stimulating investment and hiring in depressed areas under certain conditions. But in our empirical analyses, we could not show that employment growth in three Maryland enterprise zones was due to the programs. Moreover, we found that government incentives of the type used in enterprise zones were not as important in firms' business location decisions as were factors the federal government cannot control, such as market access and community or location characteristics.

Our assessment of the Maryland experience does not show that enterprise zones are effective in meeting their objectives. This does not mean that no program can be effective, but rather that we are still at the stage of finding out what can be shown to work, for which urban places and under what circumstances. Therefore, if the Congress decides to enact a federal enterprise zone program, we believe that the program should begin with a modest demonstration to determine its effectiveness, rather than the large effort proposed in H. R. 6. From our results, we conclude that more should be known about the performance and net cost of a federal enterprise zone program (both in absolute terms and in comparison with other alternatives) before one is implemented on a large scale. Valuable information on the necessary ingredients for an effective program could be gained from a careful evaluation of a limited demonstration project implemented under a variety of urban conditions, particularly if that were coupled with a parallel demonstration of a project designed to increase labor mobility.

We believe also that a demonstration project should be designed to test ways of rewarding only firms' employment and investment decisions <u>that result from the program</u>. Our findings suggest that many employers in the Maryland program may have legally won financial windfalls from program credits for behavior that they had already exhibited or would have in the absence of the program. A federal program should be designed to avoid this potentially expensive and wasteful trap.

This concludes my prepared statement, Mr. Chairman. I will be happy to respond to any questions that you or members of the Committee may have.

H.R. 3232, 99th Congress, and the Maryland EZ Program Compared

H.R. 3232	Maryland
Eligibility and duration	
Area must satisfy all the following:	Area or proximity must satisfy at least one of the following:
Population of at lease 4,000 if within a metropolitan statistical area of 50,000 or more; otherwise, population of 1,000 or within an Indian reservation	
Unemployment at least 1.5 times the national level	Unemployment at least 1.5 times the national or state level, whichever is higher
At least 20% of population below national poverty level	Population in area or proximity below 125% of national poverty level
At least 70% of population below 80% of local median income	At least 70% of families below 80% of local median income
Area experienced a 20% decrease in population 1970-80	Area or proximity experienced a 10% decrease in population in years between censuses and either chronic property abandonment or substantial property tax arrears
Wholly within jurisdiction of local government eligible for assistance under section 119 of Housing and Community Development Act of 1974	
State and local government agree to a probusiness course of action	
Designation for a maximum of 24 years	Designation generally effective for 10 years
A maximum of 100 areas may be designated	A maximum of 6 EZs may be designated in any 12-month period; no county may receive more than one new EZ in any calendar year
Employment tax credits	
10% credit for increased employment expenditures, up to $17,500 per year[a]	Up to $500 tax credit for each new job filled by worker not disadvantaged and not rehired
50% of wages paid to disadvantaged	Tax credit for each new job filled by disadvantaged worker who was not rehired, up to $3,000 over 3 years
	Tax credit for a worker rehired after being laid off by the firm for more than 6 months, up to $1,750 over 2 years
5% tax credit to qualified workers, up to $10,500 in wages[a]	
Investment and property incentives	
10% investment tax credit for new construction property[a]	Property tax credit of 80% of increase in assessment value from improvements, decreases after 5 years
Nonrecognition of capital gain on EZ business property	
Deduction for purchase of stock of an EZ firm	
Suspension of limitations on cost recovery deductions for property financed with industrial revenue bonds in the case of EZ property	
Ordinary loss deduction for securities of EZ businesses that become worthless	
	Up to 100% guarantee for long-term loans to finance business activity
	Higher loan limits for local government land acquisition and development projects
	Funds of 25% over the maximum funds available from state redevelopment fund for use within an EZ
Research credit of 37.5% for research conducted in EZs	

[a]The credit gradually decreases for last 3 years of the EZ.

Appendix II

EMPLOYMENT GROWTH ANALYSES

We used an interrupted time series design to evaluate the effects of the Maryland enterprise zone program on employment growth for areas that had enterprise zones. We analyzed the data with autoregressive moving average (ARIMA) modeling techniques. Ideally, the intervention studied in this analysis should be a discrete event that occurs at a well-defined point in time and that can be expected to be observable as an immediate change in the outcome measure. In regression terms, the intervention is specified as a dummy variable that changes from 0 to 1 when the event occurs.

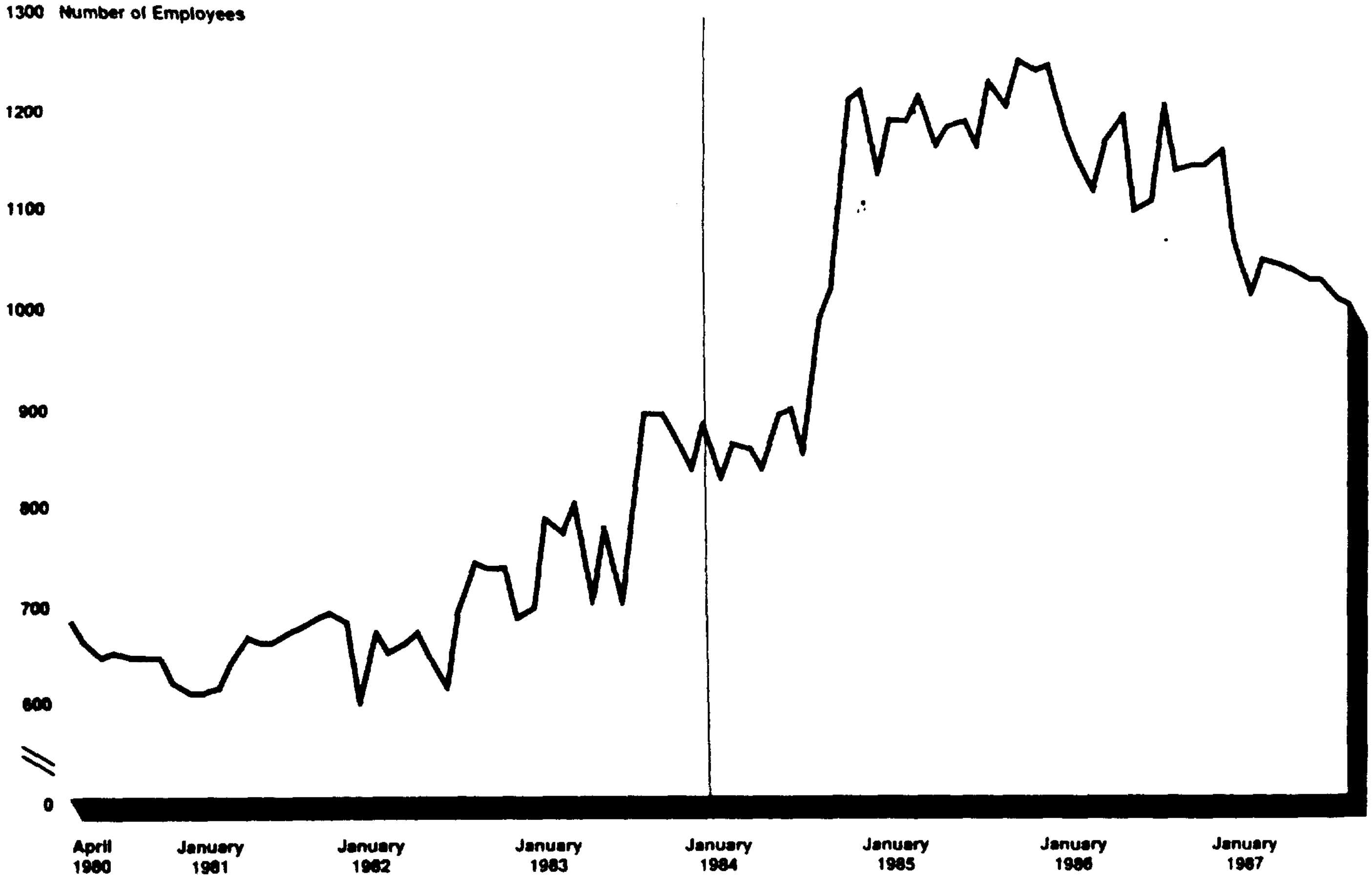
For example, in our analysis of an enterprise zone's effect (the intervention) on the number of workers employed by program participants (the outcome), the dummy variable changed from 0 to 1 on the date when the local enterprise zone became operational. However, since we knew that several employers did not begin their participation in the program until many months later, our analysis also considered models that describe an enterprise zone's effect as a gradual increase over several months until it reached a new and stable level. ARIMA modeling is particularly well suited for this situation.

We analyzed unemployment insurance data on the aggregated employment levels of program participants from April 1980 to September 1987. We focused on participants because their employment patterns would be most likely to show the effects of the program. We analyzed the data separately for each study site. the trends for each site are shown in figures II.1 through II.3.

The ARIMA analysis of these trend data indicated that statistically significant increases in employment occurred at two of the sites several months after implementation of those enterprise zones (see figures II.1 and II.3). This could have led to an interpretation that the employment growth resulted from the zone incentives. To check this interpretation, we identified the firms responsible for the observed employment increases. In some cases the decisions predated the firms' participation in the program, so the decisions could not be attributed to the incentives. In the remaining cases we interviewed firm officials on the reasons for the location or hiring decisions reflected in the trend data. In all but one case those officials informed us that they had already decided (or probably would have decided) to locate in the zone or increase hiring, regardless of the program. The remaining firm provided no clear response on this issue, but it accounted for only a few jobs.

Figure II.1

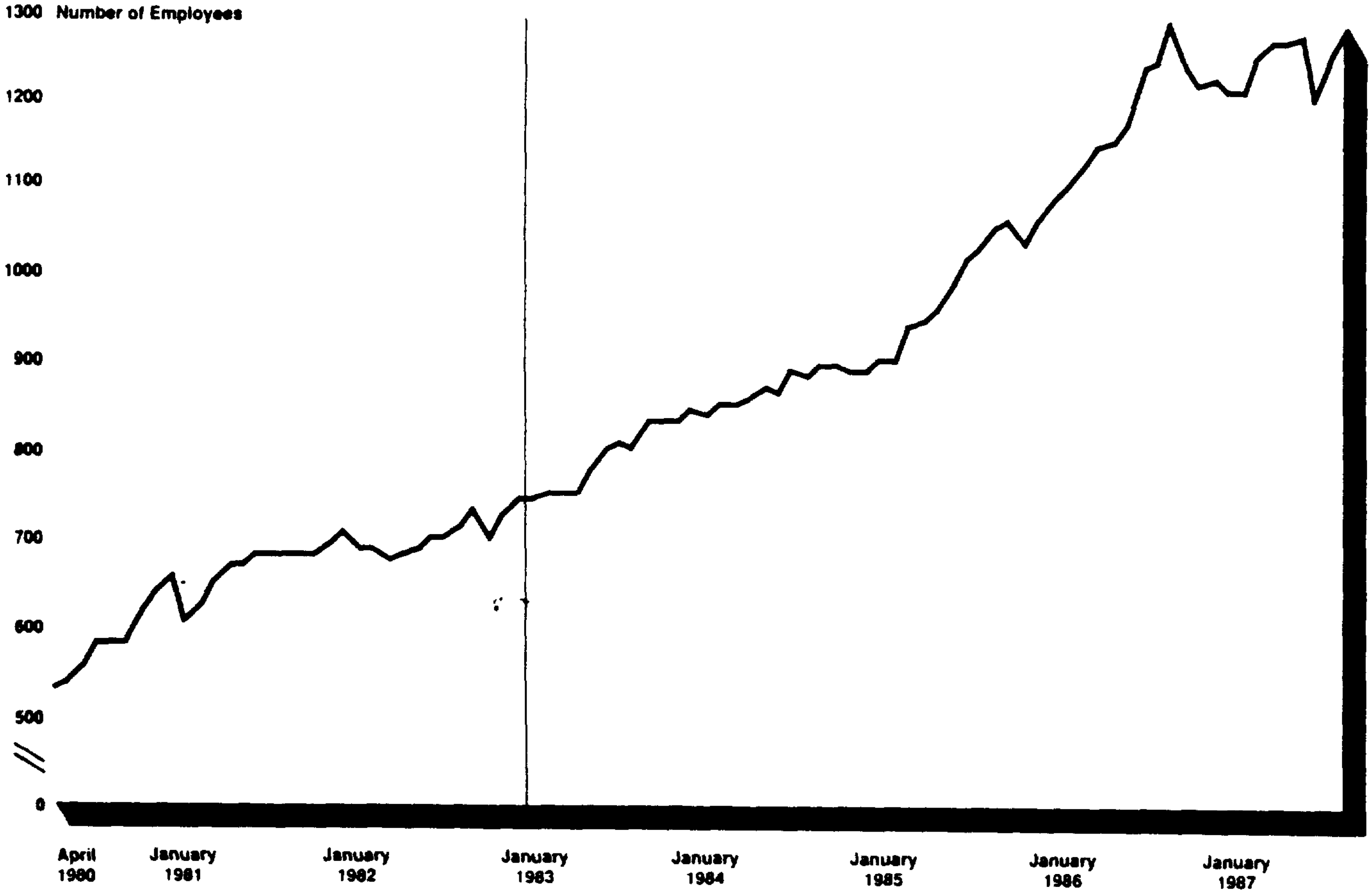
Number of Employees for Participants in the Hagerstown EZ 1980-87[a]



[a]The vertical line represents the intervention of the program.

Figure II.2

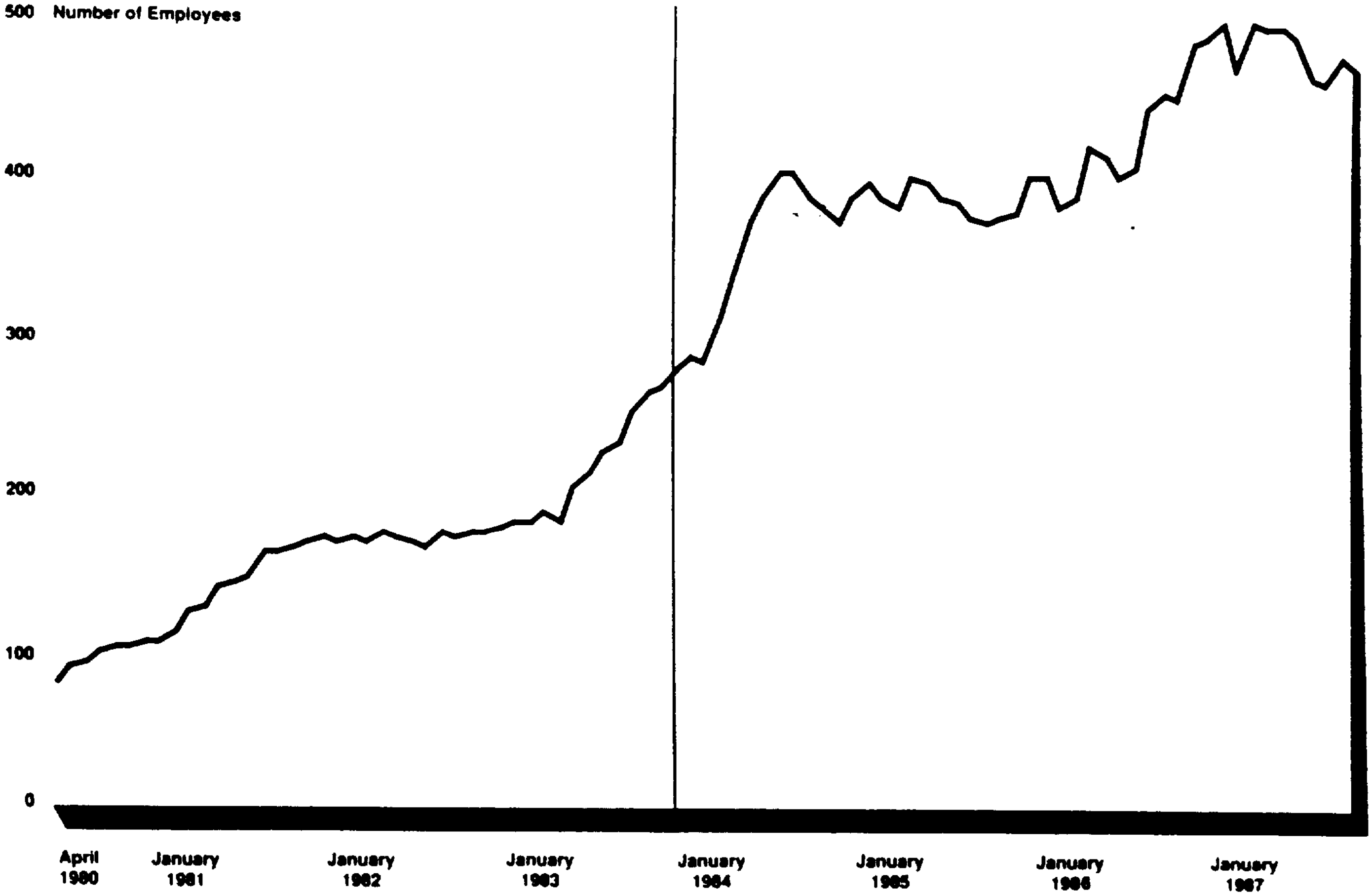
Number of Employees for Participants in the Cumberland EZ With One Participant Excluded 1980-87[a]



[a]The vertical line represents the intervention of the program.

Figure II.3

Number of Employees for Participants in the Salisbury EZ With Two Participants Excluded 1980-87[a]



[a]The vertical line represents the intervention of the program.

Appendix III

SURVEY OF EMPLOYERS

We surveyed employers in four Maryland enterprise zones and in one area in Maryland that did not have an enterprise zone. The survey provided information primarily for addressing our question on the relative effectiveness of different tax incentives and other local development strategies.

INSTRUMENT

We developed three versions of a mail survey that were tailored to our three main employer groups: program participants, nonparticipants, and employers in the nonenterprise zone area. All versions requested the following types of information from potential respondents:

1. employers' assessments of the importance of 13 various factors on employers' most recent location decision, using a five-point index of importance;

2. employers' assessments of the importance of 7 features similar to those of the Maryland enterprise program and 12 features similar to those of a proposed federal enterprise zone program on employers' hiring and investment decisions using a five-point index of importance;

3. employers' assessments of the importance of six various nonfinancial economic development strategies on employers' hiring and investment decisions using a five-point index of importance;

4. employers' suggestions for incentives that a federal enterprise zone could offer to achieve development objectives; and

5. characteristics of the employers' businesses in the area of study, such as location status, number of employees, and primary business activity.

Additional information was collected with one or more versions but not all, as appropriate: experience with the Maryland enterprise zone program, the influence of the Maryland enterprise zone program on hiring and business location, and reasons for not participating in the program. All the versions included instructions and a pledge of confidentiality.

RESPONSE RATES AND POTENTIAL BIAS IN RESULTS

Despite our best efforts, we did not receive responses from all the employers to whom we sent questionnaires. The overall response rate for our survey was about 54 percent. A greater proportion of participants responded (69.9 percent) than did either nonparticipants (52.6 percent) or employers in the nonenterprise zone area (51.3 percent).

The relatively low response rate, especially for the enterprise zone nonparticipants, raises concern about the representativeness of our respondent group. The low rate increases the likelihood that our respondents do not adequately represent the population from which they were drawn and leads to potential bias in our results. To identify the extent and nature of bias, if any, we compared the respondents with their respective populations or with nonrespondents. These comparisons suggested that, overall, the respondents represented their populations well.