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## The Effectiveness of State Enterprise Zones

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## The Effectiveness of State Enterprise Zones

*NOTE: This article highlights some of the research findings soon to be published in the authors' new book, **State Enterprise Zones: Do They Work?** Check our Web site — <http://www.upjohninstitute.org> — for availability.*

Although originally conceived as a federal program for helping distressed inner-city areas, enterprise zones have become a central pillar of many states' economic development efforts. In most states, zones have been used to focus economic development policy on poorer areas. The justifications for such targeting range from the arguments of spatial mismatch theorists, who claim that inner-city minorities have particular difficulty accessing the buoyant job markets of the suburbs, to Timothy Bartik's work showing that the efficiency of economic development policy is likely to be improved by focusing benefits on the disadvantaged.

State and local enterprise zone programs consist mainly of tax instruments: property tax abatements, sales tax exemptions, and income tax deductions, credits, and exemptions for employment creation, capital investment, or income creation in the zones. In this article we provide brief answers to the following questions: 1) Are these zone tax incentives big enough to induce firms to locate into zones? 2) Do zone incentives induce new job growth and, if they do, who gets these jobs? 3) How costly are these incentives?

### **Are Enterprise Zone Incentives Large Enough?**

To answer this question we employ a computer micro-simulation model, TAIM<sup>ez</sup>, to measure how the actual incentives available in each of the enterprise zones in our study would improve a firm's rate of return on an investment in a new manufacturing facility in that zone. TAIM<sup>ez</sup> is a hypothetical firm model that includes computer algorithms for the calculation of state and local corporate taxes and incentives in our sample of 75 enterprise zones in 13 states from 1990 to 1998. The "firms" in the model are actually a set of financial statements constructed to be representative of actual firms in each of 16 manufacturing sectors. (The workings of the model are described in Peters and Fisher, forthcoming). The result is an estimate, year by year for 20 years, of the increase in after-tax cash flow attributable to the firm's investment in a particular city and enterprise zone, with and without "generally available tax incentives" (available both in and out of enterprise zones), and with and without zone incentives.

In the average zone among our 75, the total tax incentive package available (both general and enterprise zone incentives) lowered the effective tax rate on a new plant by about a third. In 13 zones, the incentive package cut the tax rate by more than half. (The effective tax rate is the state and local tax liability as a percent of the pretax cash flow from the new plant.) The average tax rate before incentives among the cities ranged from 5.2 percent to 22.8 percent, while the average rate after incentives ranged from 1.4 percent to 11.7 percent.

In the policy context, it is often useful to judge the size of incentives by the dollar value to the firm per new plant job. Our measure is the value of the incentives to the firm discounted over 20 years at 10 percent. In other words, it is the lump sum tax-free grant that would be equivalent in value to the incentives, for a firm with a 20-year planning horizon. In the average zone, the total incentive package was worth about \$5,000 per job, but it reached a value of \$10,000 per job or more in five zones and was less than \$2,000 per job in eight zones.

Tax incentives are usually thought to have their largest effects on the intrametropolitan location decision, where other spatially variable factors, such as labor and transportation costs, are about equal. Within a metro area, at least within a given state, the nonzone incentives will also be equal. Only the additional differential provided by a zone location will affect the intrametropolitan location decision. How large is this differential?

In 3 of our 13 states (Florida, Virginia, and Wisconsin), there are no general incentives. At the other extreme are 5 states (California, Connecticut, Kentucky, Missouri, and New York) that provide the least relative advantage to zones; here the zone incentives make up less than 40 percent of the total incentive package. In the remaining 5 states, there are both general and zone incentives, but the zone incentives make up 69 percent to 81 percent of the package.

Another way of getting at the question of the importance of zone incentives is to consider the size of the wage premium that an incentive package would just offset. Wages are a much larger component of costs than are taxes (about 14 times as large, on average), and wage rates can vary substantially from one place to another. Again using TAIM<sup>sz</sup>, we calculated the hourly wage differential at a new plant location that would provide the firm with the same present value of cost savings over 20 years as the enterprise zone incentives available there. Indiana provided the most valuable zone differential at 6.8 percent of wages. But the zone incentives were equivalent (on average across sectors and cities) to a wage reduction of just 0.7 percent to 2.5 percent in 11 of the 13 states. A small wage premium (2.5 percent or less) would be sufficient, in most locations, to wipe out the advantages created by zone incentives.

### **Do Zone Incentives Result in New Jobs?**

The last section suggests that most enterprise zone incentives are too small to materially affect the investment and location behavior of most firms. Do empirical studies provide any reason to doubt this deduction? Studies of enterprise zones fall into a much broader literature looking at the effects of taxes on growth. This literature has been surveyed a number of times (see Bartik 1991 and Wasylenko 1997); suffice it to say that there is some agreement that state and local taxes in general have a measurable, but modest, impact on growth. However, the econometric literature on the effects of enterprise zones incentives in particular is small. While a few early studies did find enterprise zones to be effective, most of the evidence suggests that zones have almost no influence on local growth (see Wilder and Rubin 1996, Fisher and Peters 1997, and Peters and Fisher, forthcoming).

Why do enterprise zones perform so poorly? First, the extra inducement a firm receives from enterprise zone incentives is quite small when put in terms of the wage equivalent. Second,

enterprise zones are typically in areas with poor infrastructure, poor connections to the transportation system, high crime, and so on. As Dabney (1991) has argued, enterprise zone incentives would have to be very large indeed to make up for these obstacles to investment.

Who gets the (very) few jobs actually created by zone incentives? For zones to be judged successful, a substantial share of the jobs that are created must be filled by inhabitants of enterprise zones or surrounding poor neighborhoods. It turns out that the jobs in zones are often taken by nondisadvantaged individuals living far from the targeted areas. Many states attempt to counter this problem by restricting incentives to jobs filled by certain kinds of persons. Of the 13 states we looked at, 11 offered some sort of jobs credit program, and all 11 targeted those credits either to zone residents or to population groups that were economically disadvantaged. The targeting of jobs credits is effective, however, only if firms are able and willing to use them. The cost of complying with jobs credit targeting requirements appears to be much higher than the cost of claiming, say, an investment tax credit on an income tax return. This may be why the Ohio jobs credit, while fairly generous (\$3,000 per job), is used by fewer than 10 percent of firms locating in enterprise zones.

A larger problem is that capital incentives tend to dominate labor incentives; thus, the jobs credit may be viewed as irrelevant. A fairly average job credit (\$2,000) fully utilized in its first two years reduces wage costs of a job paying \$12.00 per hour by a mere 48 cents. How many targeted individuals become attractive hires at a wage of \$11.50 for the first two years who would not have been hired at the standard wage of \$12.00? It is easy to imagine that targeted employees have perceived productivity differentials valued at far more than 48 cents an hour by most zone employers.

### **How Costly are Enterprise Zone Incentives?**

Do state and local governments gain or lose revenues as a result of enterprise zones? In our study we found that, on average, state and local governments would gain about \$18,000 in revenue over a 20-year period for each job that was induced to locate in the state because of the zone incentive package. On the other hand, governments would lose about \$6,600 for every job that received incentives unnecessarily (the plant would have been built in the state anyway).

An induction rate can be calculated from empirical work on the inter-state elasticity of economic activity with respect to taxes, which appears to be in the range of  $-0.1$  to  $-0.6$ . If we take  $-0.3$  as the elasticity, this implies that the typical incentive package (which represents about a 26 percent reduction in taxes for the firm) in our sample cities would produce less than a 10 percent increase in the flow of new jobs into the state. This, in turn, means that there are far more jobs draining revenues from the state and locality at the rate of \$6,600 per job than there are jobs providing the net gain in taxes of \$18,000 per job. The net effect in our 75-zone sample was a total state-local revenue loss of about \$59,000 for every new job induced by incentives.

## Suggestions for Further Reading

- Bartik, Timothy. 1991. *Who Benefits from State and Local Economic Development Policies?* Kalamazoo, Michigan: W.E. Upjohn Institute for Employment Research.
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