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BY THE COMPTROLLER GENERAL

Report To The Congress

OF THE UNITED STATES

Revitalizing Distressed Areas Through Enterprise Zones: Many Uncertainties Exist

The administration has proposed the enterprise zone concept as a new approach to revitalize distressed areas by providing tax relief and regulatory reform. Objectives would be to stimulate business development and create jobs.

Many unknowns exist about the effectiveness of the proposed incentives and their costs. For example, will the zones attract substantial private investments, create jobs, and/or result in adverse effects? And because Federal costs for the program will depend upon response to the incentives offered rather than congressionally controlled appropriations, will the actual program costs be more or less than estimated?

If the Congress enacts an enterprise zone program, GAO agrees with the administration that it should be undertaken on an experimental basis. Further, GAO recommends that enterprise zone legislation require the administering Federal agency to establish program effectiveness criteria supported by systematic data collection and evaluation to analyze the benefits and costs of the program.

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To the President of the Senate and the
Speaker of the House of Representatives

This report raises questions about the enterprise zone approach to revitalizing distressed areas and notes that many uncertainties exist concerning this proposed program. We made this review to assist the Congress in its deliberations on enterprise zones.

We are sending copies of the report to the Director, Office of Management and Budget, and to the Secretaries of Housing and Urban Development and the Treasury.

Charles A. Bowsher
Comptroller General
of the United States

COMPTROLLER GENERAL'S
REPORT TO THE CONGRESS

REVITALIZING DISTRESSED AREAS THROUGH ENTERPRISE ZONES: MANY UNCERTAINTIES EXIST

DIGEST

Enterprise zones have been proposed by the administration as an experimental program to revitalize distressed urban and rural areas. Proposed program objectives are to attract businesses and jobs to these areas (enterprise zones) through Federal tax, regulatory, and other governmental incentives. GAO recognizes that questions about the program's ability to attract investments and create jobs are presently difficult to answer with any certainty. Consequently, GAO believes that if an enterprise zone program is tried, an evaluation mechanism should be established at the outset to determine whether the program's benefits are worth its costs.

While several enterprise zone proposals, including one by the administration, have been introduced in the Congress, none has been enacted into law. To assist the Congress in its deliberations on enterprise zone proposals, GAO reviewed the concept, as well as previous GAO reports on economic development and job creation, to identify issues concerning business development, job creation, and costs of such a program.

Although the specific elements of enterprise zone legislation have not been set, the concept taken as a whole represents a substantial departure from past Federal urban development initiatives, which GAO generally had previously found had visible but limited effects. While caution should be used in drawing conclusions based on experiences of previous direct subsidy efforts or tax incentives offered nationwide, GAO believes these experiences should not be ignored, and may prove instructive in providing insight into the many uncertainties that exist with the enterprise zone concept. (See pp. 1 to 4, and app. II.)

POTENTIAL PROBLEMS IN ATTRACTING BUSINESSES AND PREVENTING ADVERSE EFFECTS

Federal tax relief will be one major way to stimulate business development in enterprise zones. This relief, however, will not eliminate distressed area problems, such as high crime rates and infrastructure decay. Enterprise zone proposals have addressed these needs by proposing that Federal tax relief be reinforced through (1) Federal regulatory relief, (2) involvement of other Federal programs, and (3) local, and possibly State, commitments. However, tax relief, even if coupled with these proposed reinforcements, may have a limited effect in attracting businesses to distressed areas because:

--The Economic Recovery Tax Act of 1981 may have reduced the attractiveness of enterprise zone tax incentives because it provided significant tax reductions to businesses without imposing any geographic restrictions. However, the administration believes there will still be heavy tax burdens to be reduced. (See p. 6.)

--Tax relief may not be sufficiently attractive to many businesses with limited or no tax liability, such as many new, small businesses. (See p. 12.)

--Local and State governments may not be able to make needed but costly commitments for alleviating distressed area problems. (See p. 14.)

--The extent to which other Federal programs will support enterprise zones is unclear. (See p. 15.)

--It is unclear what Federal regulatory relief would be offered in enterprise zones. (See p. 17.)

Under the administration's proposal, State and local governments could ask Federal regulatory bodies to relax or eliminate a broad range of nonstatutory regulations within the zone, but it is unknown what regulatory relief would be requested and granted. The administration has stated, however, that regulations relating to civil rights or those that would endanger the public health or safety would not be affected. (See p. 17.)

Even if enterprise zone incentives were sufficient to attract businesses into a distressed area, they could have adverse effects. For instance, the proposed tax relief could:

--Place businesses operating outside of a zone in a weaker competitive position than their zone counterparts. (See pp. 8 to 10.)

--Encourage business relocations, merely shifting economic activity and jobs from one area to another without creating new, net economic activity and jobs. (See pp. 11 and 12.)

--Lead to residential displacement. For example, if tax incentives are capitalized into increased rents, low-income residents who cannot afford these increases could be displaced. The administration has said, however, that it plans to encourage zone boundaries which exclude heavily residential areas. (See pp. 39 to 41.)

EFFECTIVENESS OF PROPOSED EMPLOYMENT INCENTIVES IS UNKNOWN

The administration's enterprise zone proposal contains tax incentives designed to encourage (1) the hiring of disadvantaged workers, (2) the creation of jobs for workers of all types, and (3) workers to accept employment in an enterprise zone. While the effectiveness of these proposed incentives is unknown, the incentives raise questions because:

--An incentive intended to create jobs for the disadvantaged is similar to previous Federal incentives which have achieved only limited success. However, proposed enterprise zone tax credits for hiring the disadvantaged differ from similar past credits and may be more attractive because they would (1) be coupled with other incentives, (2) give businesses greater overall financial benefits, and (3) continue over a longer time. (See pp. 20 to 22.)

--A proposed tax credit to encourage the employment of workers of all types would apply only to new enterprise zone workers and for payroll increases above those existing for zone businesses prior to zone designation. Consequently, this incentive could be more attractive to new businesses and those which relocate into a zone, than to existing zone businesses. (See p. 24.)

--A proposed employee wage credit may not be sufficient to attract workers to seek jobs in a distressed area, since it is limited to $450 or less per year. Further, some low income workers will not be able to fully use the credit because they may not have sufficient tax liability against which the credit could be applied. (See pp. 25 to 27.)

ACTUAL FEDERAL COSTS FOR AN ENTERPRISE ZONE PROGRAM ARE UNKNOWN

Federal enterprise zone costs for tax incentives offered will not be limited by appropriations with a fixed spending ceiling. Rather, they will be dependent on the level of response to tax incentives, which may be available for over 20 years. Designating a limited number of zones, as proposed by the administration, would help to contain program costs. In addition, using tax credits as incentives could promote private decisionmaking and involve fewer Government-imposed decisions than federally administered grant and loan programs.

Only rough estimates have been made of the Federal cost of an enterprise zone program. A Department of the Treasury cost projection estimated that the first year alone of an enterprise zone program could cost the U.S. Treasury as much as $310 million in lost tax revenues, if 25 zones are designated. The President's fiscal year 1983 budget estimated that by 1986 the program could cost $930 million for up to 75 zones. To the extent that actual zone characteristics differ from Treasury's assumptions, however, costs could be more or less than estimated.

Actual program costs will not be known until zones become operational and revenue losses can be measured. Even then, the establishment of program effectiveness criteria and a data collection and evaluation mechanism would be needed to determine actual costs and benefits.

However, the administration's proposal does not provide for such a mechanism. (See pp. 31 to 35.)

CONCLUSIONS AND RECOMMENDATION

The administration has proposed enterprise zones as an experimental program. GAO agrees that if an enterprise zone program is established, it be on an experimental basis because of the many unknowns about how well the program will work, what adverse effects it may have, and what it will cost. Further, GAO believes that the benefits and costs of the program should be identified through program effectiveness criteria supported by systematic data collection and evaluation. Consequently, GAO recommends that the Congress include a provision in enterprise zone legislation, if it is enacted, requiring the administering Federal agency to establish a program evaluation mechanism.

AGENCY COMMENTS AND GAO's EVALUATION

The administration agreed that many questions surround the enterprise zone approach to urban revitalization. (See app. V.) It also agreed that research design and program effectiveness criteria must be established. The administration said, however, that it would not be advisable to legislatively mandate the type of research design or criteria to be used. GAO is not implying that the specifics of the evaluation be legislatively mandated. Rather, the thrust of the recommendation is that the legislation, if enacted, should require the administering Federal agency to establish a program evaluation mechanism since such a provision was not included in the administration-supported enterprise zone bill. (See pp. 41 and 42.)

Additionally, the administration reiterated and supplemented its views on a number of enterprise zone issues, such as the potential for residential displacement, business relocations, and regulatory relief to be provided.

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ABBREVIATIONS

AFL-CIO	American Federation of Labor and Congress of Industrial Organizations
CBO	Congressional Budget Office
CETA	Comprehensive Employment and Training Act
CRS	Congressional Research Service
GAO	General Accounting Office
HUD	Department of Housing and Urban Development
TJTC	Targeted Jobs Tax Credit Program
WIN	Work Incentive Program

CHAPTER 1

INTRODUCTION

In his January 26, 1982, State of the Union Address, President Reagan endorsed enterprise zones as an experiment to improve and develop our depressed areas. On March 23, 1982, the President announced an administration-supported enterprise zone proposal to revive the decaying areas of America's inner cities and rural towns. The enterprise zone concept is principally founded on the premise that relief from taxes, regulations, and other Government burdens will spur the formation of new business activity, which will create employment opportunities in designated distressed areas.

The enterprise zone concept was proposed in Great Britain in 1978, and in 1981 the first British enterprise zones were established. The concept received attention in the United States during the second session of the 96th Congress (1980) when two bills advancing enterprise zones were introduced. During the first session of the 97th Congress (1981), six different bills were introduced. Hearings were held on one of the bills (S. 1310, companion to H.R. 3824), but no subsequent legislative action was taken. These proposals, however, have laid the framework for subsequent enterprise zone discussions by researchers, State and local government officials, and others. In addition, in 1981 the administration assigned the Cabinet Council on Trade and Commerce the responsibility to develop its enterprise zone proposal. Several preliminary enterprise zone plans were developed by the administration before its March 1982 proposal was announced. According to the March proposal, the purpose of enterprise zones would be twofold--to redevelop and revitalize the geographic areas themselves and to create jobs in depressed areas, particularly for disadvantaged workers.

Enterprise zone proposals have generally provided for tax and regulatory relief, which may be granted by Federal and local governments. (Major elements of nine enterprise zone proposals are displayed in app. I.) At the Federal level, proposed incentives have included increasing investment tax credits, reducing or eliminating capital gains taxes, and giving zone employers and employees income tax credits based on wages paid in the zone. At the local level, bills introduced in the 96th Congress required specific local commitments, such as reduced property taxes. In the 97th Congress, however, most bills have not required local commitments or have been less specific on the types of local commitments. Likewise, the administration's proposal provides for flexibility in tailoring contributions to suit local needs and preferences. In addition, the administration's proposal provides for local as well as State enterprise zone contributions from four basic categories: tax relief, regulatory relief, improved local services, and neighborhood organizations.

The number of zones to be designated has been addressed in only three of the nine proposals, and the number of years for which incentives will be provided has varied among proposals. For example, the proposed life of a zone is 5 years in one proposal and over 20 years in another proposal. According to the administration's proposal, the program would be experimental with a maximum of 25 zones approved in each of the first 3 years of the program. Federal participation in each zone would last for a period determined by State and local governments, up to a maximum of 20 years plus a 4-year phaseout.

ENTERPRISE ZONES DIFFER FROM DIRECT SUBSIDY PROGRAMS THAT EXPERIENCED PROBLEMS

Although the specific elements of the enterprise zone legislation have not been set, it is important to note that the enterprise zone concept, taken as a whole, represents a departure from past Federal urban development initiatives. These initiatives, which relied on Federal Government subsidies, included urban revitalization programs such as Community Development Block Grants and Urban Development Action Grants, antipoverty programs sponsored by the former Office of Economic Opportunity, and job creation/job training programs authorized under the Comprehensive Employment and Training Act.

Unlike previous urban revitalization and business development efforts that relied primarily on direct subsidies, enterprise zone business subsidies would be provided largely through the tax system. The job creation aspect of enterprise zones, however, bears some resemblance to previous Federal efforts that also relied on tax incentives. While caution should be used in drawing conclusions based on experiences of previous direct subsidy programs or tax incentives offered nationwide, these experiences should not be ignored and may prove instructive in providing insight into the enterprise zone concept.

The problems of other Federal programs dealing with the Nation's distressed urban areas and economically disadvantaged individuals have been recognized in our previous reviews. For example, our 1973 report concluded that a wide array of Federal incentives to promote the economic, social, and physical rehabilitation of the Bedford-Stuyvesant, New York, area had a visible but limited impact after several years of Federal funding. We reported that the effort fell short of its goals to stimulate local business development and to attract outside industry to create jobs for the community residents in part because the community's economic problems were deep seated and resisted rapid solution. In addition, our prior reviews of Federal economic development and job training programs recognized that (1) Federal agencies often had not agreed on the commitments necessary to accomplish program goals and (2) Federal job training programs have met with limited or unknown success. (See app. II for a summary of these and other of our selected reports.)

OBJECTIVES, SCOPE, AND METHODOLOGY

The overall objective of our review was to inform the Congress of the central issues involved in the proposed enterprise zone approach. Because enterprise zones, as generally discussed, would offer tax benefits to stimulate business development and create jobs in distressed areas, and because of the national concern over the level of future Federal budget deficits, our review focused on determining

--what difficulties could be expected in stimulating business development in enterprise zones;

--whether enterprise zones could be expected to create new jobs, particularly for disadvantaged persons; and

--what an enterprise zone program might cost.

It was not our intention to address all the possible issues related to the enterprise zone concept but rather to identify some of the more critical issues that may be of concern to the Congress in its deliberations on enterprise zones. Our goal in addressing the review objectives was not to make definitive statements about the consequences of different packages of enterprise zone incentives. Further, since an enterprise zone program is not currently in place, it would be premature for us to express an overall view of the effectiveness of an enterprise zone program. We have sought, primarily, to survey the current state of knowledge on the enterprise zone concept and to report on past Federal experiences where applicable.

We conducted our review in Washington, D.C., where the enterprise zone concept is being developed. The review was performed in accordance with our current "Standards for Audit of Governmental Organizations, Programs, Activities, and Functions." To address the central issues raised by the enterprise zone concept, we reviewed (1) our past reports on economic development, tax incentives, and job creation programs, (2) studies by researchers and analysts regarding urban and business problems, economic development, and unemployment, (3) enterprise zone research reports, studies, and articles, (4) legislative proposals introduced in the Congress, and (5) information on the British enterprise zone experiment. A listing of the major documents considered in preparing this report is contained in appendix III. We also identified and discussed potential enterprise zone issues with Federal and local government officials and representatives from research organizations, business organizations, and local government organizations. A listing of the organizations interviewed or contacted appears in appendix IV.

In selecting the organizations to interview, we attempted to identify a cross section of groups that publicly expressed support or concern about the enterprise zone concept as well as those whose memberships may be affected by such a program. We developed a basic set of questions, tailoring the questions to the type of group interviewed in order to acquire more relevant information.

The research, business, and local government organizations contacted provided us with information for our review, references to further sources of information, and details of their views about the enterprise zone concept and specific proposed program incentives.

Further, our review of documentary and interview evidence sought to capture experiences from past and current Federal programs that might apply to the enterprise zone concept. Our report does not discuss State and local experiments in this area because while numerous enterprise zone bills have been introduced at the State level, most had not passed at the time of our review, and those which had were only in preliminary stages of implementation.

CHAPTER 2

DIFFICULTIES IN STIMULATING BUSINESS DEVELOPMENT IN ENTERPRISE ZONES

Enterprise zone proposals are based largely on stimulating business development in distressed, targeted areas through Federal tax incentives. Geographically targeted Federal tax incentives, however, may have a limited effect or pose potential problems because:

--The Economic Recovery Tax Act of 1981 provided significant tax relief to businesses without imposing any geographic restrictions.

--Capital investment incentives, unless tied to a hiring requirement, may create only a limited number of jobs and may prove costly to the Treasury, as there is no limit on possible tax reductions.

--Nearby businesses would not be entitled to enterprise zone tax benefits, and their competitive position in relation to zone businesses could be weakened.

--Previous State and local tax differentials have generally had a limited influence on business location decisions. Nevertheless, it is possible that some businesses will relocate to take advantage of enterprise zone tax incentives, which could have the effect of only shifting existing businesses and jobs from one area to another.

--Different size firms and sectors of the economy will benefit differently from proposed tax incentives.

Reduced taxes may not adequately compensate businesses for disadvantages often associated with distressed areas, such as high crime rates and infrastructure decay. Enterprise zone proposals have addressed this issue by proposing reinforcement for Federal tax incentives through (1) State and/or local commitments, (2) involvement of other Federal programs, and (3) Federal regulatory relief. While some State and/or local governments may not be in a position to respond to enterprise zone problems with costly commitments, such commitments may be critical to the success of a zone. It is also unclear to what extent other Federal programs will support enterprise zones. Further, it is uncertain what Federal regulatory relief will be provided.

Many questions surround the proposed enterprise zone program. An important one is: Will the program succeed in stimulating business development and, if so, will it cause unintended effects? If the program is tried, the administering Federal agency will need to answer this and other questions to assess program results.

RECENT GENERAL BUSINESS TAX REDUCTIONS DILUTE PROPOSED ENTERPRISE ZONE TAX INCENTIVES

After eight enterprise zone bills had been introduced in the Congress, major Federal tax reform legislation (the Economic Recovery Tax Act of 1981, Public Law 97-34) was enacted. This legislation provides some of the same types of tax incentives as those contained in enterprise zone proposals without imposing any geographic restrictions. Moreover, by reducing business taxes nationwide, the Economic Recovery Tax Act may reduce the relative attractiveness of business tax incentives proposed for enterprise zones.

For example, several enterprise zone bills provide for more rapid depreciation of capital assets and increased investment tax credits. Similarly, the Economic Recovery Tax Act already allows a business to more quickly recoup capital investments through an accelerated cost recovery system. This system was established to provide more rapid depreciation of capital assets over 3-, 5-, 10-, and 15-year periods and liberalization of investment tax credits.

The accelerated cost recovery system, in effect, reduces the corporate tax rate. As explained by the Urban Institute, 1/ the nominal corporate income tax rate is 46 percent, but the effect of accelerated depreciation and the investment tax credit is to reduce this nominal rate. The Institute reported that for the business community as a whole, the effect of the accelerated cost recovery system was to reduce the effective corporate tax rate to 18 percent, though this effect varies according to industry. For example, under prior law, the effective corporate tax rate for the manufacturing industry was 37 percent, but the accelerated cost recovery system was estimated by the Urban Institute to reduce this rate to 14 percent. A spokesperson for the National Association of Manufacturers told us that proposed enterprise zone tax incentives may not be substantial enough to attract manufacturers because proposed enterprise zone incentives have been mitigated by the recently passed Economic Recovery Tax Act.

A March 1982 administration paper states that even after the Economic Recovery Tax Act is phased in, most corporations will still have a 30- to 35-percent marginal tax rate and, according to the administration, there will still be heavy tax burdens that enterprise zone incentives could reduce.

In commenting on a draft of this report (see app. V), the administration stated that the Economic Recovery Tax Act reduced marginal tax rates on personal income from all sources. However,

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1/"Enterprise Zones and the Corporate Income Tax," The Urban Institute (Nov. 1981).

the administration noted that enterprise zone tax incentives and regulatory reduction would provide further benefits. We agree that enterprise zone incentives could be attractive to some businesses; however, our point was to recognize that recent tax legislation may have reduced the relative attractiveness of enterprise zone tax incentives.

CAPITAL INVESTMENT INCENTIVES POSE POTENTIAL PROBLEMS

Two key enterprise zone business tax provisions that have been proposed in most enterprise zone proposals are capital gains tax reduction or elimination, and investment tax credit liberalization. The administration's proposal, for example, provides for up to 10-percent investment tax credits, which is in addition to investment tax credits available nationwide, and elimination of capital gains taxes on qualified property. A memorandum outlining the administration's proposal states that the additional investment tax credit is intended, in part, to encourage the development of commercial and industrial structures. The elimination of capital gains taxes is intended to encourage capital improvements, which the administration's memorandum noted were needed if zone areas were to become desirable places to work and live and if jobs are to be created within them.

A potential problem with capital investment incentives, however, is that unless they are tied to a hiring requirement, they may create only a limited number of zone jobs. In fact, we previously reported 1/ that the investment tax credit may distort normal market forces and lead to more intensive use of capital at the expense of labor because, by lowering the cost of assets, the relationship between labor and capital is altered. However, our report noted that it is impossible to predict whether the demand for labor will rise or fall as a result of the credit.

In May 1981, the Assistant Secretary for Policy Development and Research in the Department of Housing and Urban Development (HUD) noted that the Cabinet Council on Trade and Commmerce expressed the opinion that enterprise zone tax incentives should not encourage capital investments in zones which provide few jobs, such as large warehousing facilities. The Assistant Secretary stated that an alternative would be to make the capital incentives contingent on the creation of a certain number of jobs or on the conduct of job-related activities. However, he cautioned that this would increase the complexity of the tax incentives and the regulations applicable to zone activity, thus undercutting the effectiveness of the program. The Assistant Secretary further noted that an attempt to narrowly target the incentives toward labor-intensive activities, and thus control the development of

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1/"Investment Tax Credit: Unresolved Issues" (PAD-78-40, May 8, 1978).

zone activity, would be a departure from the original concept of the program, which was to roll back government burdens and let the market determine the course of development within the zones. In August 1981, an administration plan for enterprise zones noted that it seemed best that a disadvantaged person hiring requirement not be imposed on zone businesses, as the same goal could be achieved through a tax credit, which the administration included in its March 1982 proposal. (See ch. 3 for a discussion of the administration's proposed employment tax credits.)

Another concern with proposed investment tax credit and capital gains provisions is that they could be very costly to the Treasury in lost tax revenues, if there is no limit on the tax reductions that would be possible. Dr. Stuart Butler of the Heritage Foundation told us that without some limit on businesses' total investment that would be eligible for income tax concessions, such as capital gains elimination, enterprise zones could offer considerable opportunities for tax writeoffs but have little impact on the poor. The August 1981 administration plan noted that a dollar limit could be placed on the value of property placed in service each year. Although the administration plan noted that limits of $500,000 to $5 million had been suggested, its March 1982 proposal does not have a dollar limit.

NEARBY NONENTERPRISE ZONE BUSINESSES MAY BE AT A COMPETITIVE DISADVANTAGE

Enterprise zone tax incentives are intended to facilitate business development in targeted distressed areas, yet the benefits provided may inadvertently place businesses operating outside of a zone in a weak competitive position in relation to their zone counterparts. Opinions presently differ on whether business competition is likely to be a problem associated with enterprise zones. However, some businesses have expressed concern with the British enterprise zone experiment.

The possibility exists that businesses outside the zone border would face unfair competition from zone businesses receiving Federal income tax reductions. Dr. Stuart Butler of the Heritage Foundation notes that, to some degree, this effect is unavoidable. He states that small businesses in Britain have been particularly irritated by what they see as the possibility of firms on the wrong side of the zone border facing unfair competition from zone firms with generous tax breaks and minimal regulation. One particular British enterprise zone received strong opposition from local businesses in the vicinity. Within a month of the zone announcement, 200 local small businesses joined together to launch a campaign against the zone.

However, Dr. Butler also cautions that this issue should be put in perspective, as an upward spiral created by enterprise zones would help nearby businesses, just as a downward spiral hurts them. The concern that businesses outside zone borders are likely to suffer, according to the Sabre Foundation, appears to be overstated, for if a zone is successful it will establish an upward economic spiral for the area. A similar view was expressed in an administration paper of March 1982, which states that firms are usually better off if they are on the edge of an economically booming area than if they are on the edge of a severely declining one.

Other organizations, however, have expressed concern that enterprise zones will discriminate against nonzone firms, take away their business, and cause shutdowns and relocations. For example:

--A spokesperson for the American Federation of Labor and Congress of Industrial Organizations (AFL-CIO) said a firm outside the zone, employing many zone residents, would receive no benefit. This would lead to inequitable situations and a powerful incentive for shutdowns, relocations, and counterproductive competition.

--The Chamber of Commerce of the United States expressed the opinion that geographically bounded tax incentives are inherently inequitable and discriminatory and, therefore, inconsistent with sound Federal tax policy.

--An official of the National Federation of Independent Business said his association is concerned that if service or retail businesses are successful in an enterprise zone, they will probably just be taking business away from firms outside a zone.

Furthermore, a Department of Commerce memorandum of February 1981 stated:

> "Small firms tend to be in the service sector. For the most part, service sector firms compete with other firms in the same community. A new dry cleaner simply diverts business from other dry cleaners located nearby. There is no increase in the number of suits and dresses that need cleaning; hence there is no net increase in employment. To be sure, an enterprise zone firm would compete to a limited extent with firms outside the zone but in the same city."

In commenting on a draft of this report (see app. V), the administration noted that economically distressed areas eligible for enterprise zone designation generally have a much higher cost of doing business than other areas. According to the administration, the effect of the enterprise zone incentives will be to offset these higher costs. In addition, the administration noted that firms just outside the zone should benefit substantially if the program is successful. We agree that this is a possibility. On the other hand, it is also possible that the competitive position of businesses outside of a zone could be weakened as their zone counterparts can take advantage of tax and regulatory relief not available to them.

TAXES' INFLUENCE ON BUSINESS LOCATION DECISIONS

Taxes are generally only one of many factors businesses consider in their location decisions and generally are not considered to be the determining factor. Previous State and local geographic tax differentials have generally had a limited effect, but enterprise zone tax incentives may encourage some existing businesses to relocate to an enterprise zone. If this happens, the effect may be only to shift existing businesses and jobs from one area to another.

Previous tax influence on business location decisions has been limited

Before a business locates in an area, it generally considers an array of factors, such as the availability of a trained work force; adequacy of existing infrastructure and public services (police, fire, sanitation, and transportation); and market accessibility. Taxes are also a factor many businesses consider in making location decisions; however, they are generally not considered to be the determining factor.

For instance, a representative of the National Association of Manufacturers told us that at least three factors would rank higher than taxes in manufacturers' location decisions: (1) accessibility to raw materials, (2) accessibility to the requisite skilled labor force, and (3) geographic proximity to the end market. A Coopers and Lybrand director noted at a February 1981 enterprise zone conference that most analyses have concluded that location and investment decisions are based on a comparative cost analysis (labor, capital, transportation), with various types of incentives perhaps serving as a tie breaker in choice of a specific site, once a general region is selected.

Tax differentials and concessions offered among jurisdictions generally have not had a significant influence on firm location decisions, according to a HUD research paper on enterprise zones. The paper noted that one reason for their lack of influence lies in the relatively small tax differentials that generally exist among jurisdictions, which may not adequately compensate firms for other larger cost and market differences that exist among locations. In addition, a publication of the Joint Center for Urban Studies 1/ noted that State and local tax incentives are either not applicable or of low concern to the typical plant looking to relocate. However, this publication cautioned that this is not to say that tax breaks, if offered, will be spurned by industry.

1/"The Prospective City," Joint Center for Urban Studies (1980).

Rather, the publication noted that available evidence suggests that the effects of tax levels on decisions to relocate are only overwhelmed by other, more fundamental, considerations.

Enterprise zone tax incentives may encourage business relocations

Even though previous State and local tax incentives may have had a limited influence on business location decisions, it is possible that some businesses will relocate to take advantage of enterprise zone tax incentives that may be more attractive than those previously offered. As explained in a March 1982 administration paper, the proposal includes tax relief at the Federal, State, and local levels, which will be far more comprehensive and dramatic than any package of targeted, or untargeted, tax relief ever offered in the past.

The administration further noted that the intent behind the program is primarily to stimulate new economic activity within the zones that otherwise would not have occurred at all, anywhere, rather than to encourage existing outside activity to relocate into the zones. The administration reported that relocation of existing businesses is actually quite uncommon; in fact, less than half of one percent of all employment changes in the country are due to the migration of firms. However, an August 1981 administration plan stated:

> "Some relocation will inevitably occur and is certainly tolerable. Indeed, the program will probably be perceived as a success, both politically and economically, even if much of the resulting zone economic activity is due to such relocation. But massive relocation may cause serious problems for areas outside the zones."

This plan further noted that the unknown degree to which firms will relocate in zones makes it very difficult to calculate the potential fiscal impact of the program. However, for purposes of program cost estimation, a Department of the Treasury cost estimate assumed that 90 percent of the increase in enterprise zone business activity would represent relocations, according to HUD and Treasury officials.

An administration plan noted the potential for relocation by large firms could be reduced by placing a dollar limit on capital tax incentives offered, but no such provision was included in the administration-supported enterprise zone bill.

The administration's comments on our draft report (see app. V), noted that the enterprise zone program is designed to avoid luring businesses away from their current locations. Further, the administration stated that (1) relocation of existing businesses is actually quite uncommon and (2) the intent behind the program is to stimulate new economic activity. However, its comments do not specify how the program would preclude or minimize business relocations. Furthermore, as discussed above, a program cost estimate assumed that 90 percent of the increase in enterprise zone business activity would represent relocations.

BUSINESS ASSESSMENTS OF ZONE INCENTIVES AND IMPEDIMENTS ARE LIKELY TO VARY

Various size firms and sectors of the economy are likely to assess differently the incentives and impediments connected with enterprise zones. In terms of incentives, the proposed Federal tax provisions may not encourage some businesses to locate in a zone, because nonrefundable tax reductions will be viewed as beneficial only by those businesses that expect to have a tax liability.

Characteristics often associated with distressed areas, such as high crime rates and low market potential, may discourage some businesses from locating in a zone. For instance, consumer market-oriented businesses may not be attracted to some potential enterprise zones because of the residents' low incomes and the low market potential.

Federal tax incentives will not be valuable or beneficial to some businesses

Proposed nonrefundable tax incentives can be attractive to those businesses with tax liabilities, but a large number of businesses do not have net income which results in tax liabilities. For example, in 1977, 2,241,887 corporations filed Federal income tax returns, of which only 1,424,528, or 63 percent, had net income. Enterprise zone nonrefundable tax credits would be of limited value to firms with little or no profit, unless the credits could be: (1) applied to old or future tax liabilities or (2) sold to a profitable firm under a leaseback arrangement.

Enterprise zone benefits to small businesses are an important issue according to research by David Birch 1/ on the types of establishments and firms generating jobs. This research found that small firms (those with 20 or fewer employees) generated 66 percent of all new jobs in the United States between 1960-76. However, the benefits of nonrefundable Federal tax reductions may be of limited value to small businesses. As a HUD Special Assistant to the Assistant Secretary for Policy Development and Research explained to us, incentives for small businesses are difficult to devise because most small businesses incur little or no tax liability in their early years; thus, nonrefundable tax incentives are not of much help to them.

1/"The Job Generation Process," David L. Birch (1979).

A memorandum explaining the administration's proposal also recognized that new businesses generally suffer losses in their initial years, and it may be several more years before they have sufficient profit or tax liability against which to deduct their tax credits. The administration's proposal, however, would allow an enterprise zone business to carry over an operating loss or any unused employment tax credits for the life of the zone or 15 years, whichever is longer. The administration explained that this carryover extension will reduce the risk, particularly for small businesses, of starting a new business.

Tax reductions, even large ones, do not reduce the risk of failure for new businesses, according to a HUD enterprise zone research paper. This risk, as calculated by the Urban Institute, 1/ indicated that for firms with 20 or fewer employees, only 37 percent survived past 4 years and 17 percent survived past 9 years.

In commenting on a draft of this report (see app. V), the administration said that many of the Federal tax incentives will help small businesses. For example, according to the administration, capital gains tax elimination will help small entrepreneurs, who start and build up new businesses, to receive the full value of their effort when they sell out. Further, the administration noted that the enterprise zone initiative is not just a Federal tax incentive program, as it involves removing all types of government burdens on economic activity. As we noted, however, some businesses, such as new small businesses, which often do not have tax liabilities, will not benefit in the critical early years of operation from many, nonrefundable Federal tax incentives. In addition, we recognize that the administration's proposed Federal tax incentives are designed to be reinforced through Federal regulatory relief as well as State and local commitments.

Enterprise zone impediments may affect business response

Enterprise zone tax incentives may add to the desirability of an enterprise zone location for some firms but may not adequately compensate them for the location disadvantages often associated with distressed areas. These location disadvantages are likely to vary among zones, but could include (1) high fire and property insurance rates, (2) high land clearance costs, (3) decaying infrastructure, (4) low levels of public service and protection, and (5) a generally low-skilled labor pool.

Businesses in the service or retail trade may be particularly hard pressed to operate successfully in an enterprise zone because a distressed area may not offer them a profitable market. An official of the National Federation of Independent Business, which

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1/"The Role of Small Business Enterprise in Economic Development," The Urban Institute (Dec. 1980).

has over 560,000 members, said that 65 percent of small businesses are engaged in the service or retail trade and thus are dependent on a local market. However, the official said that enterprise zone proposals do not appear to give any consideration to this need. Also, according to a HUD enterprise zone research paper, central city enterprise zones will generally have high crime rates which deter shopping by nonresidents and consumer market-oriented firms from locating there. Location disadvantages, however, may be mitigated by other government or private efforts reinforcing proposed Federal tax incentives.

REINFORCEMENT IS NEEDED FOR FEDERAL TAX INCENTIVES

Most enterprise zone proposals contain provisions which would reinforce Federal tax incentives in enterprise zones. Proposed reinforcements have included (1) State and/or local commitments, (2) Federal program support, and (3) Federal regulatory relief.

State and/or local commitments

To complement Federal income tax reductions in attracting businesses to enterprise zones, many enterprise zone proposals require local commitments as part of the total incentive package. Financially distressed local governments, however, may not have the capacity to make costly but needed commitments for attracting businesses to distressed areas and helping to ensure zone success.

Early enterprise zone bills introduced in the 96th Congress required specific local commitments, such as reduced property taxes. Most bills introduced in the 97th Congress, however, have not required local commitments, or have been less specific on the types and levels of local commitments required, thus providing greater latitude to local governments in developing a commitment package. Likewise, the administration's proposal provides for flexibility in tailoring contributions to suit local needs and preferences. In addition, the administration's proposal provides for local as well as State enterprise zone contributions from four basic categories: tax relief; regulatory relief; improved local services; and neighborhood organizations.

Financially distressed State and local governments may be hard pressed to make costly but needed commitments, such as infrastructure improvements, to an enterprise zone. For example, the Mayor of Buffalo, New York, testified 1/ that for business to exist and grow, there must be a basic municipal infrastructure and support services to assist it. Yet after 150 years of wear

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1/Testimony of James D. Griffin, Mayor of the City of Buffalo, New York, before the Subcommittee on Tax and Access to Equity Capital and Business Opportunity of the House Small Business Committee on Sept. 15, 1981.

and tear, the Mayor said that Buffalo, like New York, Chicago, and every other older American city, must spend hundreds of millions in the next few years just to restore its basic systems. In light of this financial burden, the Mayor stated that there is no guarantee that Buffalo can meet the demands of new development, let alone service what is there.

A memorandum outlining the administration's proposal recognized that a major concern expressed by State and local officials is that the enterprise zone program will force them to forego tax revenues when they are already facing tight budgets and insufficient revenues. However, the administration explained that its proposal does not require any particular State or local tax reduction. Moreover, the administration stated that the fiscal ability of the State or local government to provide tax relief will be considered in the competition for Federal approval, and a weakness in one area, such as tax relief, could be compensated for by a strength in another area, such as regulatory relief.

State and local government contributions, however, may determine which areas are selected as enterprise zones and may be critical to a zone's success. The White House announcement of the administration's proposal stated that a key criterion for choosing which proposed zones will receive Federal designation will be the quality and strength of the incentives to be contributed by the State and local governments. The announcement further stated that State and local contributions to a zone will probably make the difference in whether a zone succeeds or fails. A November 1981 paper by the Department of the Treasury's Office of Tax Analysis stated that in a large enterprise zone with diversified and reasonably active existing businesses, Federal tax credits, by themselves, may produce very little incremental activity without the support of State and local government incentives. Similarly, a July 1981 Department of Commerce enterprise zone paper noted that tax incentives alone will probably not be enough of an inducement unless a city or county government can assure a business that other considerations are satisfactory. These other considerations were noted as crime rate, transportation and utility access, building security, lighting, code enforcement, and adequacy of the labor force.

Federal program support

Two enterprise zone bills (H.R. 3824 and H.R. 2965) have provided for Federal interagency coordination, but others have not, or the coordination has been limited to expediting foreign trade zone 1/ applications. For example, under the administration's proposal, other Federal agencies would not provide special

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1/Foreign trade zones are enclosed areas considered outside the customs territory of the United States.

support through their programs for enterprise zones. The administration explained that tying other programs too closely to enterprise zones may cause them to grow along with the zone program, undercutting the administration's efforts to reduce government spending and improve the overall economy. However, State and local governments would have complete discretion to use the Federal funds from such programs as community development block grants or revenue sharing for their enterprise zones.

In contrast, one enterprise zone bill (H.R. 3824) states that the Secretary of Housing and Urban Development should promote the coordination of all Federal housing, community and economic development, small business, banking, financial assistance, and employment training programs which are carried on within an enterprise zone. However, details of this coordination and the exact roles and responsibilities of other Federal agencies are not addressed.

If Federal coordination for enterprise zones is determined to be needed, past programs have shown that unless the involvement of other agencies is sufficiently detailed, anticipated results may not be realized. For example, in our 1972 report 1/ on HUD's Model Cities Program, we reported that the program's success depended to a great extent on the continuous support of, and funding and staffing by, participating Federal agencies. Yet HUD and other Federal agencies often had not agreed on the appropriate levels of Federal funding and staffing commitments necessary to accomplish the program's goals. If enterprise zones are to be supported, in part, through other Federal programs, it would be beneficial to define the roles and responsibilities of the appropriate Federal agencies at the outset of an enterprise zone program.

In commenting on a draft of this report (see app. V), the administration said that its enterprise zone proposal provides for consultation by the Secretary of HUD, who is responsible for zone selection and implementation, with the Secretaries of Agriculture, Commerce, Labor, and the Treasury; the Office of Management and Budget; and the Small Business Administration. In addition, the proposed legislation requires the Secretary of HUD to coordinate HUD programs in enterprise zones. The administration explained that while the proposed legislation does not require targeting Federal programs, their application in enterprise zones by local and State officials is very likely. As noted above, we believe that unless the involvement of other agencies is sufficiently detailed, anticipated results may not be realized.

1/See app. II for a further discussion of our report.

Federal regulatory relief

Most Federal enterprise zone legislative proposals have not addressed Federal regulatory relief for enterprise zones. Further, in two proposals that have, it is not clear precisely what regulatory relief would be provided.

One legislative proposal (H.R. 3824) extends the Regulatory Flexibility Act to enterprise zones. This act requires all Federal regulatory agencies to publish analyses of the economic impact of any proposed regulations on entities under its coverage (small businesses, nonprofit organizations, and small governmental jurisdictions) and to discuss alternatives to those regulations. The act also requires that all Federal regulatory agencies undertake a periodic review of all their regulations to determine whether they should be changed to minimize their economic impact on the entities covered under the act. However, the administration stated that this act appears neither to require nor provide any new, explicit authority for any substantive regulatory changes. A memorandum outlining the administration's proposal pointed out that the Regulatory Flexibility Act:

> "* * *is a useful element to be included in the Enterprise Zone program. It will force agencies to focus on the impact of their regulations in Enterprise Zones and publicize this impact. But the Act does not appear to provide any authority for any substantive regulatory changes. It is not even clear that the Act empowers agencies to make different regulatory rules for the entities under the coverage of the Act. Something more is needed."

Under the administration's proposal, Federal regulatory bodies would be given discretionary authority to relax or eliminate their nonstatutory regulatory requirements within enterprise zones, in accordance with standards promulgated by the Congress, but only upon the request of State and local governments. While a broad range of regulatory requirements may be able to be eliminated within an enterprise zone, the administration has stated that the Federal Government would have no authority to relax any regulations relating to civil rights or change any regulations if doing so would endanger the public health or safety.

It is uncertain what regulatory relief may be forthcoming under the administration's proposal, since State and local governments would have to ask Federal regulatory bodies to relax or eliminate nonstatutory regulations within the zone and Federal agencies would have the power to grant such requests at their discretion.

In commenting on a draft of our report (see app. V), the administration said that the legislative language concerning Federal regulatory relief is intentionally nonspecific in order to permit local and State governments to exercise maximum initiative in this regard.

CONCLUSIONS

The success of enterprise zones in stimulating business development in distressed areas is unknown and will remain so until the proposed program is tried and has been operating for some time. Questions which will then need to be addressed to determine success in stimulating business development and unintended effects include:

--To what extent did the Economic Recovery Tax Act reduce the relative attractiveness of business tax incentives for enterprise zones?

--What revenue loss is resulting from capital investment incentives? Is there a corresponding level of benefits in terms of new businesses and jobs?

--What effect are enterprise zones having on businesses operating outside of a zone? If their competitive position has been weakened, what corrective measures are needed?

--Are businesses relocating in enterprise zones to take advantage of zone incentives? If so, to what extent is relocation occurring and what effect is it having?

--How does business response to enterprise zone incentives and impediments vary according to firm size and sector? If certain businesses, such as small businesses in the service sector, are not being attracted to enterprise zones, should additional action be taken? If so, what should be done and by whom?

--How are enterprise zones being reinforced through (1) State and local commitments, (2) Federal programs, and (3) Federal regulatory relief? What effect is this reinforcement having?

If the program is tried, the administering Federal agency will need to address these questions, as well as questions concerning job creation in chapter 3 and program costs in chapter 4. Chapter 4 also contains a recommendation relating to questions raised throughout the report.

CHAPTER 3

THE EFFECTIVENESS OF ENTERPRISE ZONE

EMPLOYMENT INCENTIVES IS UNKNOWN

One objective of most enterprise zone proposals is to stimulate the creation of new jobs, particularly for disadvantaged 1/ people, by offering businesses income tax credits for hiring new workers. Similar Federal tax credits have been aimed at improving the employment prospects of disadvantaged individuals but have managed to achieve only limited success.

A general business tax credit for hiring enterprise zone workers has also been proposed as an employment incentive. Since a similar tax credit has never been tried before, its effectiveness is not known. However, because the credit could apply only to new enterprise zone workers and to the increase of an existing zone firm's payroll over its prezone level, it would be more attractive to new businesses and those which relocate into a zone than to existing zone businesses.

Another untried tax incentive proposed for enterprise zones is a tax credit for enterprise zone employees. This credit, proposed at 5 percent of wages, would represent a minimal wage subsidy for workers at all income levels. In addition, since this credit would benefit employees who are working at existing zone businesses, it could be costly to the Treasury without producing any employment increases.

If proposed business and employee tax credits can only be applied against a tax liability, and credits in excess of a tax liability cannot be refunded in cash, they are likely to be of limited value to many businesses and low wage earners that owe little or no taxes.

How well enterprise zone employment incentives will work is uncertain and will remain so until an enterprise zone program is tried and evaluated. We raise several questions which we believe need attention and study in assessing the program's results, if an enterprise zone program is enacted. These questions focus on the effects which enterprise zone tax incentives would have on

--businesses hiring disadvantaged and nondisadvantaged workers and

--employees accepting jobs in enterprise zones.

1/Definitions of disadvantaged workers vary in different enterprise zone proposals, but they generally address certain common target groups, including general assistance recipients or their families, low-income (poverty level) family members, and handicapped people.

NO ASSURANCE EXISTS THAT JOBS WILL BE CREATED FOR DISADVANTAGED PERSONS

Federal enterprise zone legislative proposals would allow a business to claim Federal income tax credits for wages it pays disadvantaged workers within a zone to encourage the hiring of this group. The Federal Government has previously offered businesses tax credits to encourage such hiring, but business response has been low and only a limited number of jobs have been created for disadvantaged group members.

If all other enterprise zone tax incentives were contingent on hiring disadvantaged people, program costs would only be incurred if there were employment gains for this group. However, such an approach can have drawbacks as well. In either case, however, a system to verify eligibility for disadvantaged worker credits may be needed. While such a system could prove costly and administratively burdensome, its absence could lead to abuse in credits being claimed for ineligible workers.

Business tax credits for hiring disadvantaged persons have achieved limited results

A memorandum outlining the administration's enterprise zone legislative proposal noted that a disadvantaged worker tax credit will encourage employers to hire and train low-income and hard-to-employ workers and will improve their productivity and make them more employable. The administration's proposal includes a 50-percent tax credit for wages paid to disadvantaged workers. Of four enterprise zone bills introduced in 1981 that provide disadvantaged worker tax credits for creating new jobs, one provides businesses a 5-percent tax credit for hiring disadvantaged people and three propose increasing by 10 to 15 percent an existing employer tax credit under the Targeted Jobs Tax Credit (TJTC) Program.

The TJTC Program, started in 1979, provides businesses nonrefundable tax credits for hiring members from several designated target groups, most of whom are disadvantaged. TJTC allows a business to claim a maximum tax credit of $3,000 on each worker's first-year wages (50 percent of the worker's first $6,000 in wages) and $1,500 on the worker's second-year wages (25 percent of the first $6,000). Before August 1981, the credit was also subject to a limitation on the amount of qualified first-year wages a business could claim, equaling 30 percent of a business's aggregate Federal unemployment tax payroll up to $6,000 per worker.

Our report 1/ on TJTC found low utilization of the program by businesses. We reported that while an income tax-based wage

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1/"Comments on Employment Tax Credits" (PAD-81-73, June 5, 1981).

subsidy program may be a potentially useful tool for combating chronic unemployment, TJTC's very narrow targeting approach produced a program that was apparently underutilized and, in all likelihood, had zero net impact on the employment levels of the target group members. An Assistant Secretary of the Department of the Treasury testified in April 1981 that the financial incentives provided by the targeted credits have not greatly affected employers' decisions to hire eligible workers and recommended that the program be discontinued. However, the 1981 Economic Recovery Tax Act extended TJTC to cover eligible workers hired before January 1983.

Another tax credit, started in 1971, was intended to increase the employment of welfare recipients who participated in the Work Incentive (WIN) Program. The WIN tax credit initially provided businesses a 20-percent nonrefundable tax credit against a worker's first-year wages but was modified in 1978 to provide businesses the same tax benefits as TJTC.

Although the WIN tax credit has been in effect for over 10 years, employer response to the credit has been low. The Department of the Treasury reported in April 1981 that even with an all-time high of 53,000 WIN credit-eligible workers in 1980, 80 percent of the credit-eligible workers went to work for employers who did not claim the WIN credit on their income tax returns. In other words, at a maximum, only 20 percent of the 1980 WIN credit-eligible workers could have been hired due to the WIN credit. A 1977 Congressional Budget Office (CBO) study 1/ suggests that the low utilization of the WIN credit may be due, in part, to employers' perceptions of (1) the WIN workers as poor risks and (2) the WIN Program as entailing too much Federal Government red tape. The Economic Recovery Tax Act discontinued the WIN tax credit as a separate program and merged it into the TJTC Program.

Proposed enterprise zone tax credits for hiring the disadvantaged differ from TJTC and WIN credits in that they may (1) be coupled with other incentives, (2) provide businesses a greater overall financial benefit, and (3) continue over a longer time. For instance, the administration's proposed credit would be offered to businesses over a longer period (3 years, with a 10-percent phaseout each year after that) and does not include any wage ceilings or limitations on the credits. As a result, the enterprise zone credits could be more attractive to businesses than the TJTC or WIN tax credits. Moreover, the administration has noted that an enterprise zone disadvantaged worker tax credit is one part of a broader package of tax relief and other items to apply within the zones and therefore is not comparable to the TJTC Program in its ability to stimulate jobs and economic revitalization. Nevertheless, we believe that businesses' low response to past

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1/"Employment Subsidies and Employment Tax Credits," CBO, (Apr. 1977).

Federal tax credits for hiring the disadvantaged raises questions about whether or to what degree proposed enterprise zone employer tax credits will achieve more positive results.

A hiring requirement has both merits and drawbacks

A hiring requirement, as a prerequisite to receiving Federal enterprise zone tax incentives, could reduce the likelihood that businesses will be able to claim certain enterprise zone tax credits without hiring disadvantaged persons. However, the administration of such a requirement by the Federal Government and employers could be burdensome, and certain businesses might be discouraged from locating in an enterprise zone because not all businesses can effectively use a fixed percentage of disadvantaged workers. However, it may be possible to modify a hiring requirement to reduce its potential adverse effects on business development.

Of the six enterprise zone bills introduced in the Congress in 1981, five included some type of a hiring requirement. Such a provision can have the effect of ensuring that firms locating in the zones cannot claim major enterprise zone tax incentives, such as capital gains reductions, without creating jobs for the disadvantaged. For example, one enterprise zone bill (H.R. 3824 and companion, S.1310) requires that a business hire 40 percent of its workforce from a group of predominantly disadvantaged persons to qualify for enterprise zone Federal tax incentives.

The administration's enterprise zone legislative proposal, however, does not include a hiring requirement in order for businesses to qualify for other enterprise zone tax incentives. A May 1981 administration paper noted that the absence of a hiring requirement would simplify program administration. An August 1981 administration preliminary plan for enterprise zones further noted that a hiring requirement would substantially discourage zone investments by businesses not suitable for hiring a large portion of disadvantaged workers.

Others have suggested similar reasons for not including a hiring requirement provision in enterprise zone legislation. For example, Dr. Stuart Butler stated that a hiring requirement could limit business development in enterprise zones, since some businesses (particularly small businesses) might be unable to effectively use a fixed percentage of disadvantaged workers. Dr. Butler also believes that a small new firm may be more stifled in keeping the necessary records to meet the hiring requirement than would, for example, a large existing firm. Further, a spokesperson for the National League of Cities stated that a hiring requirement applied to all enterprise zones may be too restrictive and inappropriate in some local situations, discouraging firms from entering the zones and attracting only firms offering dead-end jobs.

A hiring requirement could be modified to reduce some of the potential adverse effects on business development by applying it only to firms above a certain size, or scaling the tax incentives to the number of disadvantaged workers hired. Dr. Butler believes that if a hiring requirement is included in an enterprise zone program, it would be sensible to exempt firms below a minimum workforce size, such as 10 workers, from the requirement. This exemption could help encourage the development of small business activity within a zone that a hiring requirement may have otherwise discouraged. While this approach may provide some assurance that disadvantaged persons would realize a share of the benefits in an enterprise zone program, it nonetheless places restrictions on businesses over the minimum size limit and potentially involves a greater degree of administration than would an enterprise zone program without a hiring requirement.

Scaling an employer tax credit according to the relative number of disadvantaged persons each business hires would provide greater benefits to those businesses meeting enterprise zone hiring objectives. For example, a new firm hiring 50 percent of its workforce from disadvantaged groups might be entitled to a greater percentage of tax incentives than would a similar firm whose newly hired workforce is only 10-percent disadvantaged. However, like an unconditional hiring requirement, it could pose administrative complexities to the incentive arrangements. Also, because hiring of the disadvantaged would not be mandatory, there would be little assurance that Federal income tax benefits would result in the creation of jobs for people in this group.

In commenting on a draft of this report (see app. V), the administration expressed opposition to a hiring requirement for disadvantaged workers as a prerequisite to receiving Federal enterprise zone tax incentives. The administration believes that the cost of any hiring requirement would not clearly be exceeded by the benefits that might be realized. While we recognize that any hiring requirement would have disadvantages (such as increased administrative complexity), a hiring requirement would reduce the likelihood that businesses will be able to claim certain enterprise zone tax credits without hiring any disadvantaged persons.

Determining eligibility for wage credits could be troublesome

An eligibility verification system may be needed to determine which workers are eligible for credits offered for hiring disadvantaged people. While a controlled eligibility verification system could prove costly and administratively burdensome, its absence could lead to abuse in credits being claimed for ineligible workers.

Eligibility verification systems for disadvantaged enterprise zone workers have been recognized in several enterprise zone legislative proposals. For example, three bills provide that a worker must be certified as qualified for a business to claim employment tax credits. Similarly, the administration's proposal provides that business tax credits for disadvantaged workers are dependent on worker eligibility certifications through State employment security agencies, as administered by the Department of Labor.

Our report 1/ on the Comprehensive Employment and Training Act (CETA) public service jobs program noted that about 10 percent of the 1,800 people working at sites surveyed by the Department of Labor had been ineligible. The major causes of error in determining CETA eligibility were the reliance on participant-supplied information and the lack of standard verification procedures. A 1978 CBO report 2/ on CETA noted that program prime sponsors (mostly State and local governments) had little incentive for detailed eligibility screening because they were allowed 60 days, during which enrollees were working, to determine the eligibility of enrollees, and no sanctions were provided (such as requiring repayment of disbursements to ineligible individuals). Department of Labor officials, including the Chief of the Employment and Training Administration's Program Review Division, told us that a costly system of eligibility screening had to be implemented for the CETA program in order to minimize ineligible participant abuse rates.

While the enterprise zone concept generally aims to remove administrative burdens, the absence of Federal involvement in activities such as eligibility determinations and verifications could lead to abuses of tax credits for disadvantaged workers.

In commenting on a draft of this report (see app. V), the administration strongly supported State or local determination and verification of worker eligibility for wage credits. According to the administration, States and localities, through the use of designated local agencies, are just as competent as the Federal Government in determining and verifying worker eligibility for wage credits. We are not questioning State and local competence; we are merely recognizing that these governmental levels would have no financial incentive to prevent abuse of tax credits since wage credits would come at the expense of the Federal Treasury.

EFFECTIVENESS OF GENERAL BUSINESS TAX CREDIT FOR HIRING ZONE WORKERS IS UNKNOWN

The administration's enterprise zone legislative proposal includes a 10-percent general tax credit to employers for wages paid to their zone workers. The purpose of the incentive is

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1/"Information on the Buildup in Public Service Jobs" (HRD-78-57, Mar. 6, 1978).

2/"CETA Reauthorization Issues," CBO (Aug. 1978).

to encourage the creation of jobs for workers of all types and to attract labor-intensive business to the enterprise zones. It is unknown whether this purpose could be achieved through the tax credit because the targeting of general Federal employment tax incentives to distressed areas has not been tried before. However, the credit may be more attractive to new businesses and those that relocate into a zone than to an existing zone business.

The general tax credit presented in the administration's proposal would be allowed for any new employment, or increased wages paid within the zone, up to a $1,500 credit per employee. For a firm located in the zone prior to zone designation, this tax credit would apply only to the payroll of its zone workers above the prezone levels, including any payroll increases.

For a new enterprise zone business or a business that relocates into an enterprise zone, however, the tax credit is available for its entire workforce. In this case the credit has the potential to not only reward new business startups in the zone but also to encourage relocations. Yet relocations may not represent net, new economic activity or jobs. For example, the Assistant Director for Economic Research of the AFL/CIO told us that this tax incentive would be attractive to a highly mobile, labor-intensive business, such as a clothing manufacturer. He also said that the incentive may cause such businesses to relocate into an enterprise zone to gain an operating cost differential over its competitors, which would not create any net, new economic activity or jobs but would result in lost Federal tax revenues.

The administration's comments on our draft report (see app. V), said the 10-percent employer tax credit is designed to avoid giving a windfall to existing businesses, as well as to encourage business expansion. We agree with the administration's intent to avoid giving windfalls. However, we remain concerned that existing zone businesses could be at a competitive disadvantage compared to businesses that relocate into a zone; and that this provision could encourage relocations.

EMPLOYEE TAX CREDITS MAY BE OF LIMITED VALUE TO WORKERS

A provision that would give workers a Federal income tax credit against their salaries has been proposed as a means to encourage them to work in an enterprise zone. Geographic targeting of employee tax credits, however, is a new approach to dealing with distressed area employment problems, and therefore the potential response of enterprise zone employees to these tax credits is unknown. However, at a 5-percent level such as the administration has proposed, this credit may be of little value to all zone workers and may prove unnecessarily costly to the Treasury for existing workers in the zone.

One bill (H.R. 3824 and companion, S.1310) would give qualified zone employees a 5-percent refundable 1/ tax credit against their zone wages and other earned income over the life of the enterprise zone, up to a maximum tax credit of $1,500 per year. Under the administration's enterprise zone proposal, qualified zone employees would be allowed a 5-percent nonrefundable income tax credit for taxable income earned in zone employment, up to a $9,000 income limitation per zone worker, or a maximum credit of $450 annually. The proposal states that the tax credit will increase wages for employees working in the zones and returns to low-income workers who, by accepting a job, give up welfare or other assistance. It further notes that the tax credit will also be important in inducing highly skilled workers to accept employment within the zones, which may initially be undesirable places to work.

The administration's proposed employee credit, however, represents only a minimal wage subsidy for workers at all income levels. For example, at a minimum wage of about $7,000 annually, the credit would amount only to about $350 per year. The following chart illustrates the effect of the administration's proposed employee tax credit at various worker salary levels:

Annual income	Total tax credit ($450 limit)	Wage subsidy as a percentage of total wages
$ 7,000	$350	5.0
10,000	450	4.5
20,000	450	2.3
30,000	450	1.5

As the chart indicates, as a worker's income rises, the worker benefits proportionately less from the credit. However, higher income workers will probably be able to use the full credit to offset or reduce their tax liability, whereas lower income workers may not have sufficient tax liability to use the full credit.

The employee credit would also benefit employees who are working at existing zone businesses and thus could be costly without producing any employment increases. For example, the Department of the Treasury estimated that this credit could cost $4.4 million per year for each zone with 10,000 employees, or over $100 million for 25 zones, even if the zones experience no growth.

1/A refundable tax credit provides a taxpayer a cash refund for the credit amount not offset by the taxpayer's tax liability.

In commenting on a draft of this report (see app. V), the administration said that this credit is designed to be oriented toward the lower income worker while providing some encouragement to all persons to work in an enterprise zone. As noted above, we believe this credit will be of minimal value to workers of all types. In addition, it could cost over $100 million per year for 25 zones, even if the zones experience no growth.

TAX CREDITS MAY BE OF LITTLE VALUE IF TAX LIABILITY IS LOW

For those businesses and low-wage earners which have little or no tax liabilities, nonrefundable employer and employee tax credits would be of limited value. Nonrefundable tax credits can only be used to the extent of tax liability in a given year but generally may (within limitations) be carried forward or back and applied to tax liability in other tax years (other than the 5-percent employee tax credit). Refundable tax credits, however, would provide a taxpayer cash payments for the unused portion of a tax credit when the credit exceeds tax liability.

Most enterprise zone bills provide for nonrefundable employment tax credits. Similarly, the administration's enterprise zone proposal would provide for nonrefundable employer and employee tax credits. One bill (H.R. 3824 and companion, S.1310), however, proposes that employer and employee tax credits be refundable.

If employee tax credits are nonrefundable, some taxpayers (particularly low-wage earners) may not be able to fully use the credits. For example, a married enterprise zone employee with one child, filing a 1981 federal tax return on earnings of $7,000 per year, would receive an enterprise zone tax credit of $350 applied against a tax liability of $86, leaving $264 of the credit unused for that year. In this example, which assumes the employee files a joint income tax return, the credit's net effective value to the employee would be about 1 percent of total wages.

Utilization of the credit may be particularly low for married workers earning less than $10,000 per year and having dependent children because they may also qualify for an existing earned income credit (up to $500). According to the Assistant Director of Business Taxation of the Department of the Treasury, the administration's proposed employee tax credit would only be applied to a person's tax liability after all other credits, including an earned income credit, are applied. In this case, the effective value of the enterprise zone credit would be further reduced (possibly to zero).

Similarly, if employer tax credits are not refundable, they would not be attractive, at least initially, to businesses with little or no tax liabilities. Many businesses do not have sufficient tax liabilities to use tax credits within a given year. For instance, Internal Revenue Service records for 1977 indicate that only 63 percent of 2.2 million corporations filing tax returns had net income.

There has been some support for refundable business tax credits in enterprise zones. For example, the Mayor of New York City testified that refundable business tax credits would assist small and new firms which may not have a tax liability. Similarly, representatives of the National Governors' Association testified that refundability is particularly important to small, new firms that typically have no tax liabilities in their first few years. 1/

While employer and employee refundability provisions may enhance the attractiveness of enterprise zone tax credits, there are also drawbacks to using this approach. According to the Assistant Director of the Department of the Treasury, refundable tax credits invite greater potential abuse by businesses and workers than do nonrefundable tax credits. The Assistant Director also said that the refundable credits would increase program costs by as much as $0.9 million per zone, or $22.5 million for 25 zones in just the first program year, assuming no increase in zone activity.

CONCLUSIONS

Whether an enterprise zone program will create new jobs in distressed areas is unknown and will remain so until such a program is tried and evaluated. If the program is enacted, there are a number of important questions which warrant careful attention and study, including:

--What is the effect of a disadvantaged worker tax credit in creating new jobs for this group? If such a credit does not produce a favorable business response, what measures can be taken to improve results?

--What is the employment effect of a general worker tax credit? If it has a limited effect, is this credit necessary?

--Will a proposed tax credit for encouraging people to work in an enterprise zone be sufficient to affect their choices of employment locations or, in some cases, to forego receiving public assistance payments in favor of a job? Is this credit necessary for all enterprise zone workers?

1/Testimonies of the Honorable Edward I. Koch, Mayor of New York, and the Honorable John M. Mutz, Lieutenant Governor of Indiana, for the National Governors' Association, before the Subcommittee on Savings, Pensions, and Investment Policy, Senate Committee on Finance (July 16, 1981).

--How will businesses and workers with little or no tax liabilities respond to enterprise zone employment incentives?

Chapter 4 presents a discussion of enterprise zone program costs, general administrative concerns, and the need for a systematic program evaluation mechanism which we believe would be necessary to address the above questions.

CHAPTER 4

PROGRAM EVALUATION, COST, AND DESIGNATION CONCERNS

Because enterprise zone tax benefits are not provided by appropriations, the program's Federal costs are unknown and will remain so until after zones become operational and revenue losses from tax benefits can be measured. Even then, the establishment of a data collection and evaluation mechanism may be the only way to determine the actual costs and benefits of an enterprise zone program. However, proposals generally have not required that this be done.

There are a number of advantages and disadvantages to using the Federal tax system as an instrument of expenditure policy. For example, in keeping with the free market philosophy of enterprise zones, this approach may promote private decisionmaking and involve fewer Government-imposed decisions than do spending programs. On the other hand, tax expenditure programs may not be cost-effective and they may remain beyond their useful life because they are not periodically reviewed through the budget process.

Only rough estimates have been made of the Federal cost of an enterprise zone program. A cost projection by the Department of the Treasury estimated that if 25 zones are designated, just the first year of an enterprise zone program could cost the U.S. Treasury between $232 and $310 million in lost tax revenues. The President's 1983 budget presented a $310 million outlay equivalent for fiscal year 1984. By fiscal year 1986, this figure was increased to $930 million, which could include up to 75 zones. Federal administrative costs, as well as the costs of State and local commitments to enterprise zones, are not included in these estimates.

Estimating costs before establishing an enterprise zone program is difficult, however, because numerous factors are unknown. These unknown factors include the life of a zone, the ultimate number of zones to be designated, their size, and the level of business and employment response to the incentives offered. The extent to which offsetting benefits may result, such as increased employment and reduced welfare payments, is also unknown.

The zone designation process may entail administrative problems such as using data that may be unreliable, designating a limited number of zones from a vast pool of eligible areas, and designating those areas where residential displacement may be minimized.

The cost of an enterprise zone program is highly uncertain because of numerous unknown factors regarding the zones. A mechanism that assesses these factors through systematic data collection and evaluation will be needed to assist the Congress in answering program cost questions, such as what revenue losses are resulting from enterprise zone tax incentives and to what extent are benefits, or adverse consequences, being experienced?

A DATA COLLECTION AND EVALUATION MECHANISM IS NEEDED TO ASSESS ENTERPRISE ZONE EFFECTIVENESS

Data collection and program evaluation will be needed to assess the effectiveness of enterprise zones. However, aside from data initially required in the zone application process, enterprise zone proposals generally do not require that data be collected or that the program be evaluated. The administration's proposal, for instance, contains no provision that either of these procedures be carried out, even though the program has been proposed as experimental.

According to an analyst with the Brookings Institution, both data collection and program evaluation will be needed if an enterprise zone program is established. He suggested that a baseline survey of each enterprise zone community and business sector be conducted before the program goes into effect, followed by a second survey in perhaps 3 or 4 years, to measure the program's effects on the community and to see if it has altered business decisions in the zone. Similarly, an Urban Institute analyst stated that the ability to properly evaluate the program's effects will be critical.

Further pointing to the need for data collection and program evaluation are the unknowns that presently surround the issue of lost tax revenues resulting from enterprise zones. For instance, is it advantageous for enterprise zone benefits to be provided through the tax system?

ADVANTAGES AND DISADVANTAGES OF USING THE TAX SYSTEM TO PROVIDE ENTERPRISE ZONE BENEFITS

In contrast to previous urban revitalization efforts that relied on direct Federal subsidies with legislated spending ceilings, enterprise zones are proposed to be federally supported, not by appropriations but largely through investment and employment incentives provided by the tax code. There may, however, be advantages as well as disadvantages to this policy approach. For instance, while it may offer ease of administration, it may not be cost-effective.

A 1980 CBO report to the Congress 1/ stated that revenue losses arising from provisions in the tax code that give special tax relief to certain groups of taxpayers are called tax expenditures. Tax expenditures are payments made by the Federal Government through a reduction of taxes rather than a direct grant. The critical distinction, however, is that grants have a legislated spending ceiling, while tax expenditures do not--their costs are totally dependent on the number and types of taxpayers who take advantage of the provisions. In the case of enterprise zones, the program's cost will depend on the level of private investment and employment response to the tax incentives offered.

There are both advantages and disadvantages to using the Federal tax system as an instrument of expenditure policy. According to a Congressional Research Service (CRS) report on taxation, 2/ tax expenditure programs can promote private decisionmaking and involve fewer Government-imposed decisions than do spending programs. Further, we previously reported 3/ on the relative administrative simplicity of tax expenditure programs, stating:

> "Tax expenditures, as most of them are currently structured, are administered very simply* * *. The taxpayer's additional paperwork and bother and the Government's additional administrative costs are likely to be negligible. The Government's interference in the applicant's business or personal life will seem minor compared to that in most direct programs."

The relative permanence of tax code provisions may be another advantage to using the tax system to implement policy. The CRS report on taxation noted that policies to stimulate investment may be better implemented through the tax system because businesses may expect the incentives to continue.

However, the relative permanence of tax incentives may also be viewed as a disadvantage. The Congress may not, as with a program based on appropriated funds, be able to adjust the amount spent on enterprise zones in subsequent years, as the effectiveness of the program is assessed, or as the country's fiscal climate changes. According to the CRS taxation report, tax expenditure programs may remain beyond their useful life because tax provisions

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1/"Tax Expenditures: Current Issues and Five-Year Budget Projections for Fiscal Years 1981-1985," A Report to the Senate and House Committees on the Budget--Part III, Congressional Budget Office (Apr. 1980).

2/"Small Business Taxation, Capital Formation, and Innovation", Congressional Research Service Report No. 80-120E (Oct. 31, 1980).

3/"Tax Expenditures: A Primer" (PAD-80-26, 1979).

are not periodically reviewed through the budget process as are direct expenditures.

Once the enterprise zone program is implemented, the Department of the Treasury may be contractually bound to exempt eligible taxpayers from some or all Federal tax liabilities for the life of a zone, which, according to the administration's enterprise zone proposal, may be more than 20 years. An August 1981 administration plan noted that if a future administration is able to terminate the program, investors would have limited assurance of long-term benefits and investment might be discouraged. This problem, according to the plan, might be addressed if the Federal Government were to enter into a contract with each zone business guaranteeing the program's tax benefits for the life of the zone. The plan further stated that a future administration could probably not renege on such a contract, just as it could not refuse to pay a bill for supplies purchased by the previous administration. However, the administration's proposed bill does not include such a provision.

CRS reported another disadvantage of using the tax code, stating that it may not be a cost-effective policy instrument as tax incentives may result in substantial revenue losses without a corresponding level of benefits. This could happen if taxpayers who take advantage of the tax incentives did not have to alter their behavior in order to receive the tax savings. For example, our report on investment tax credits 1/ stated that the largest portion of the tax credits went to reward investments that would have been undertaken in any case. The report noted that while a company may increase investment outlays by only 5 percent over what was planned without the credit, the credit would allow the company to receive a tax credit on its full investment.

Finally, CRS pointed out that most tax incentives require a positive tax liability which can be offset. Therefore, individuals or firms with little or no tax liability will not respond to tax incentives. As previously noted, small businesses may be primary job creators, yet tax credits may be of limited value to this group because they often have little or no tax liability in their early years of operation.

ACTUAL COSTS ARE UNKNOWN

While the actual costs of an enterprise zone program will not be known until the program is operational and has been evaluated, the Department of the Treasury's Office of Tax Analysis has prepared several rough estimates as to the potential cost of an enterprise zone program. The cost analyses reflected only Federal revenue losses and not costs associated with Federal

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1/"Investment Tax Credit: Unresolved Issues" (PAD-78-40, May 8, 1978).

program administration or State and local commitments. These estimates were based on a broad range and level of possible Federal incentives that have been considered by the administration, and consequently they reflected a wide range of possible program costs. The most recent estimate (Dec. 1981) assumed a set of nonrefundable incentives based on the administration's planned proposal that included

--a 50-percent business tax credit for wages paid to disadvantaged employees;

--a 10-percent general business tax credit for the first $15,000 in wages paid per employee;

--a 5-percent employee wage credit up to $450 per employee; and

--an additional 3-, 5-, or 10-percent investment tax credit.

The administration's proposal also includes a provision for capital gains tax elimination. The Department of the Treasury noted that this provision was not included in its cost estimate because it is debatable whether or not this incentive would represent a revenue loss and such a loss would be difficult to quantify.

The program's first year costs in Federal tax losses were estimated to range from $9.3 million to $12.4 million per enterprise zone, or from $232 million to $310 million for 25 zones. This variance was due to different assumed rates of increased business activity in the zones. The low figure assumed no growth, and the high figure assumed a 10-percent increase in activity. A Department of the Treasury assistant director told us that program costs could be substantially higher than those in the above estimates if zone activity increased more than 10 percent.

The President's fiscal year 1983 budget estimated that an enterprise zone program which designates up to 25 zones per year, for 3 years, would result in fiscal year outlay equivalents of $310 million in 1984, $620 million in 1985, and $930 million in 1986.

The Department of the Treasury, in developing its cost estimate, made several assumptions about the average enterprise zone, including that each zone would

--be the size of a single zip code area;

--have 10,000 employees prior to zone designation; and

--have an annual product of $250 million, representing value added by labor and capital employed in the zone, with corresponding total sales of $750 million.

These assumptions are critical in estimating the cost of an enterprise zone program because, to the extent that the characteristics of actual zones differ from those assumed, the actual program costs will be higher or lower. On the issue of zone size, Treasury noted that a large number of zip code areas in many cities could be eligible for zone designation. Treasury estimated that a large enterprise zone might involve five times the cost of the zone assumed to be the size of a single zip code area. Furthermore, Treasury noted that if an area under study as a potential zone is known to generate 10 times the sales of the sample area, the cost of the incentive package in that zone would then be 10 times more than the estimated Federal tax loss for the sample enterprise zone. The unknown level of sales activity, as well as the uncertainty of other factors, make cost estimation difficult.

UNKNOWN FACTORS AND OFFSETTING BENEFITS COMPLICATE COST ESTIMATION

It is difficult to calculate reliable enterprise zone costs because numerous other factors are unknown and possible Federal budget offsets may not be measurable. The following are some of the obstacles in estimating the costs of an enterprise zone program:

--The life of a zone, or the number of years for which tax incentives will be provided, will affect the outcome of any cost analysis. Not only must costs be estimated for the first year of the program, but the cost of each subsequent year must also be projected. It is unlikely that a zone's activity will develop evenly over time, and it is probable, according to a Department of the Treasury assistant director, that in subsequent years zone costs will be higher. Among the nine enterprise zone proposals that we reviewed, the life of a proposed zone has varied. For example, H.R. 2950 provides for a 5-year zone life, whereas the administration's proposal provides for 20 years plus a 4-year phaseout period.

--It is not yet known how many zones will be designated. Only three of nine proposals we reviewed addressed this issue at all. The administration's proposal, for example, specifies that not more than 25 zones be designated in each of the first 3 years of an enterprise zone program, which would help to contain program costs.

--The potential exists for a wide disparity in the size of enterprise zones. None of the nine proposals we reviewed have included a zone size limitation. A White House memorandum outlining the administration's proposal does, however, state that on average, zones will be expected to be 1 to 2 square miles and could on occasion be as small as one-half square mile or as large as 5 square miles. Further, the Secretary of HUD will have the power to deny approval to zones which are excessively large. The administration's proposal provides that in selecting areas for zone designation, priority should be given to zones whose size and location will minimize unnecessary Federal tax losses.

--The relationship between a zone's size and its potential cost is unknown because cost is also dependent on a zone's level of economic activity. While it would appear that a large zone has the potential to be more costly to the Treasury than a small one, this may not be the case. For example, a September 1981 draft study by the Department of the Treasury looked at two potential enterprise zones in Chicago and found that the smaller one could cost the Treasury three times more than the zone twice its size. The higher cost in the smaller area was due to higher levels of existing economic activity and employment.

--It is difficult to predict accurately the number and types of firms which will be attracted to a zone. This is, in part, because it has not yet been determined what Federal tax incentives will ultimately be offered in an enterprise zone program. Even if the specific tax incentives were finalized, it would be difficult to predict how individual firms will react to those incentives. Further, each zone will have its own unique features which will affect its ability to attract business.

--It is difficult to estimate how many workers will be employed within a zone; whether their employment will represent net, new jobs; and what the cost of each job will be. The enterprise zone proposals we reviewed varied in the levels as well as types of employment credits offered, and these variances would affect an estimate of the cost per incremental job. Further, according to the Department of the Treasury's cost estimate, it is not possible to predict the percentage gain in employment in a typical zone. Moreover, Treasury noted that even if it were possible, it is not clear what cost per incremental employee would mean, as the additional jobs in the zone could be net, new jobs or they may simply be jobs relocated from other areas of the city.

It has been suggested that revenue losses associated with the program have the potential to be offset by newly generated revenues or by reduced Government expenditures. For example, according to a congressional paper on H.R. 3824, Government expenditures could be reduced by the employment of people who previously received Government aid. However, a September 1981 draft study by the Department of the Treasury stated that in no event are Federal budget offsets expected, for reductions in private costs of operating in enterprise zones are so small that when averaged over the entire national private economy, there can be no measurable overall increase on which to base an estimate of secondary tax revenues. The study noted that even if unemployment rates in the zone are reduced, experience offers no reason to believe that unemployment rates in the labor markets of which they are a part will be reduced.

THE ZONE DESIGNATION PROCESS MAY INVOLVE ADMINISTRATIVE PROBLEMS

While the enterprise zone concept is based on removing Government restrictions and bureaucratic obstacles, zone eligibility and designation may initially represent a substantial administrative burden in (1) utilizing data that may be unreliable and (2) designating a small number of zones, such as 25, from thousands of potentially eligible areas. Further, there could be an initial and continual problem arising from enterprise zone residents being displaced, but the extent of this problem may not be known unless data on residents and displacement is collected and evaluated.

Data used for designating enterprise zones may be unreliable

Zone eligibility data that may be required for the Federal zone selection process may be unreliable and may not be available on a nationally comparable basis. Zone eligibility criteria in most proposals have been based on unemployment and poverty levels. The administration's proposal additionally links eligibility to population outmigration levels, and H.R. 3824 ties eligibility to these criteria as well as chronic abandonment or demolition of structures and substantial tax arrearages. Some proposals would allow governments to supply their own data as long as they convince the Department of Housing and Urban Development that the data is reasonably accurate. However, verification of the accuracy of this data alone may create a considerable administrative problem. For example, abandonment data is not available on a nationally comparable basis and verification of such locally generated data could represent a substantial administrative task. Unemployment data has significant limitations, as well. As we previously reported, 1/ local unemployment rates are not reliable and a breakdown of labor market statistics for smaller areas lacks precision.

Unemployment data could represent an additional problem unless the unemployment rate criterion is based on a 12-month reference period or a multiple of 12 months. Most enterprise zone proposals that require unemployment data use this type of reference period. For example, the administration's proposal calls for a 12-month reference period for measuring unemployment. H.R. 3824, however, calls for unemployment rate criteria based on an 18-month period. According to the Office of the General Counsel of the Department of Commerce, the use of an 18-month

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1/"Criteria for Participation in the Urban Development Action Grant Program Should be Refined" (CED-80-80, Mar. 20, 1980).

reference period introduces a seasonal bias into the data, and would consequently create a skewed unemployment pattern. The General Counsel noted that many users of this type of data compensate for seasonal variation by using a reference period of 12 months or a multiple of 12 months. In order that the period evaluated indicate structural distress which is free of seasonal distortions, the Department of Commerce recommended that a base period of 24 months be used.

Designating a limited number of zones and ensuring their continuation may be troublesome

A substantial administrative burden may be created at the Federal level in reviewing potentially thousands of applications for a limited number of zone designations, yet both H.R. 3824 and the administration's proposal call for no more than 25 zones to be designated per year in each of the first 3 years of the program. Guaranteeing that benefits will be available for the life of each zone may also be problematic.

Selecting a limited number of zones for designation may be difficult. According to the President's message to the Congress on enterprise zones, more than 2,000 cities will have areas eligible as zones. The administration's proposal calls for an area to be nominated not only by its local government, but by its State as well before applying for a zone designation. State involvement in the nominating process could have the effect of reducing the number of areas that would otherwise apply. Nevertheless, even if only 100 eligible areas were to apply for zone designation, a competitive selection process, which the administration is proposing, may be subjective and administratively burdensome.

According to the memorandum outlining the administration's proposal, a key criterion in the competitive process would be the nature and strength of the State and local incentives to be contributed to the zones. However, a number of other factors will also be important and will be weighed heavily in this process. Some of these factors are

--high levels of poverty and economic distress in the proposed enterprise zone,

--the degree to which the size and location of the zone will stimulate primarily new economic activity and minimize unnecessary tax losses to the Federal Government, and

--effective and enforceable guarantees by the State and local governments that their proposed incentives and contributions will actually be provided for the indicated duration of the zone.

This last factor, a guarantee that State and local contributions will be provided for the life of the zone, may be very important, for the administration's proposal provides that a zone designation can be revoked if State and local governments are not complying substantially with their zone commitments. This guarantee may not only be an important factor for HUD to consider in making a zone designation, but it may also be critical to businesses that are deciding whether to locate in a zone. If businesses feel that zone benefits may not be guaranteed to them for the life of the zone, they may be reluctant to invest there and thus the attractiveness of the program might be undercut.

Designating residential areas
may cause displacement

If enterprise zone incentives make zone lands attractive and property values rise, the cost of renting a zone apartment may increase as well. If low-income residents are unable to afford these increased rents, they may find themselves displaced. Moreover, people displaced from zone property may not be entitled to any Federal relocation assistance. The extent to which displacement may be a problem will not be known unless baseline and subsequent data on residents and displacement occurrences are collected and analyzed.

A Department of Commerce paper noted that substantial empirical literature suggests that differences in local property taxes are largely capitalized into land values and rents when land is in use for economic purposes. This paper also expressed the belief that the income and capital gains tax incentives proposed by H.R. 3824 would subject land values and rents to similar capitalization. The Commerce paper suggested minimizing this potential problem by giving HUD greater authority to approve those zones with a substantial amount of vacant or abandoned properties or by requiring HUD, through designation criteria, to give selection priority to such areas. Similarly, a representative of the National League of Cities told us that the problem of residential displacement might be indirectly addressed through the zone designation process by designating zone areas which contain unused or underutilized lands. According to Stuart Butler, 1/ virtually all the sites that were designated as enterprise zones in Britain were comprised of large, vacant buildings and open land. Further, while the zones tended to be near low-income housing districts, they were practically unpopulated.

The potential for displacement could be mitigated if nonresidential areas were selected as enterprise zones. However, eligibility for enterprise zone designation, as proposed in various bills, has been linked substantially to characteristics of the population residing in the potential zone (such as poverty and unemployment levels). This guarantees that each zone designated

1/"Enterprise Zones: Greenlining the Inner Cities," Stuart M. Butler (1981).

will, in part, be residential. The Urban Institute recommended 1/ that zone eligibility criteria allow for the physical separation of the job site and residential site areas of an enterprise zone. The study suggested that the target employment population should have ready access to the job site but there need not be any people actually living within a zone. This would allow for areas substantially comprised of vacant lands and areas that are commercial and industrial to be designated as zones, thereby reducing the potential for residential displacement.

Although the administration's proposal does not expressly provide for minimizing displacement, the White House memorandum outlining the proposal recognizes this potential problem. The memorandum notes that zones should not be located in heavily residential areas, for this could lead to substantial displacement of existing residents to other parts of the city. Therefore, gerrymandering a zone boundary to exclude heavily residential areas will be encouraged. Nevertheless, displacement may still occur.

Under the administration's proposal, it may not be evident whether residential displacement has occurred, or to what extent, for there is no provision requiring that enterprise zone data be collected or that the effects of the program be evaluated. Further, if residents are displaced, they would not be entitled to any Federal relocation benefits under this proposal, for it states that no person who is displaced as a result of an enterprise zone designation will have any rights or be entitled to any benefits pursuant to the Uniform Relocation Assistance and Real Property Acquisition Policies Act of 1970. However, relocation assistance could be provided by State and local governments at their discretion.

In commenting on a draft of this report (see app. V), the administration stated that it will make every reasonable effort to minimize displacement but did not specify how this would be done. The administration further stated that enterprise zone residents will be better able to improve their standards of living and demand more and better housing, in part, because of the Federal tax incentive to hire low-income, disadvantaged persons. As discussed in chapter 3, however, zone businesses could take advantage of a broad range of enterprise zone tax incentives without hiring any disadvantaged persons, and thus there is no assurance that zone area residents will share in the benefits of zone economic activity. Finally, the administration stated that an enterprise zone investment tax credit for private construction and rehabilitation of rental housing units could result in more, not fewer, adequate housing units for zone residents. The proposed investment tax credit provisions of the administration-supported enterprise zone

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1/"Enterprise Zones: A Land Banking Approach," The Urban Institute (Sept. 1981).

bill provides for investment tax credits for commercial and industrial properties as well as residential properties. It is unclear whether or to what degree investors will elect to take advantage of the investment tax credit for residential properties, and thus it is unknown whether the housing prospects of zone residents will be enhanced as the administration suggests.

CONCLUSIONS

The administration has proposed that enterprise zones be an experimental program. We agree that if an enterprise zone program is established, it should be on an experimental basis because any Government commitments permitting taxpayers to reduce their tax liabilities could be of long duration, for an enterprise zone may last for over 20 years. Moreover, many critical questions regarding the program's costs are unknown, including:

--What would the likely costs of an enterprise zone program be?

--Would program costs be offset by newly generated revenues or reduced Government expenditures and, if so, to what extent?

--Would zone designations result in social costs?

These questions may remain unanswered even if an enterprise zone program becomes operational because

--tax expenditure programs are not assessed in the budget process by the Congress and

--enterprise zone proposals generally have not required program assessment.

We believe that the establishment of a program evaluation mechanism will be needed to determine the costs and benefits of an enterprise zone program. This mechanism should include establishing program effectiveness criteria, identifying appropriate data measures (such as economic and social indicators) at the program's outset and collecting baseline and subsequent data for the purpose of evaluating the effects of enterprise zones. Such a mechanism will help provide the Congress with needed information to make future decisions on whether the program should be expanded, revised, or terminated.

RECOMMENDATION TO THE CONGRESS

We recommend that if enterprise zone legislation is enacted, the Congress require the administering Federal agency to establish program effectiveness criteria supported by a systematic data collection and evaluation effort to analyze the benefits and costs of the program. This evaluation should be designed to address questions that include but are not limited to:

--Have enterprise zones succeeded in stimulating business development and at what cost? If successful, to what degree and what types of businesses have enterprise zones attracted? If certain types of businesses have not responded or overall business response has been limited, what additional action is needed and by whom?

--Have enterprise zones succeeded in creating jobs, particularly for the disadvantaged? If so, to what degree? What types of jobs have been created and for what types of workers? Is additional job creation action needed and if so, by whom? What revenue losses have resulted from employment incentives?

--What effect have enterprise zones had on distressed areas? Have there been unintended effects, such as (1) unfair competition for businesses not in a zone, (2) business relocations rather than new, net economic activity, and (3) residential displacement? If problems are encountered in these areas, what actions are needed to mitigate their effects?

--What has the program cost in lost Federal revenues? Have these costs been offset by benefits such as newly generated revenues or reduced Government expenditures and, if so, to what extent?

AGENCY COMMENTS AND OUR EVALUATION

The administration agreed that many questions exist concerning the enterprise zone approach to urban revitalization. (See app. V.) Regarding our recommendation, the administration agreed that research design and program effectiveness criteria must be established. It said, however, that it would not be advisable to legislatively mandate the type of research design or criteria to be used. We are not implying that the specifics of the evaluation be legislatively mandated. Rather, the thrust of our recommendation is that the legislation, if enacted, should require the administering Federal agency to establish a program evaluation mechanism, since an evaluation provision was not included in the administration-supported enterprise zone bill.

Additionally, the administration reiterated and supplemented its views on a number of enterprise zone issues, such as the potential for residential displacement, business relocations, and regulatory relief to be provided.

APPENDIX I

SELECTED PROVISIONS FROM NINE ENTERPRISE ZONE PROPOSALS

Bill number; sponsor; date introduced	Capital gains tax reduced or eliminated	Investment tax credit increased or liberalized	Employer tax credit	Employee tax credit	Targeted employee hiring requirement	Local commitment required	Federal regulatory relief	Maximum zone life (years)
H.R. 7563; Kemp (with Garcia, et al.); 6-12-80	X	X			X	X		10
H.R. 7875; Paul; 7-30-80	X	X			X	X	X	20
H.R. 390; Nowak; 1-5-81		X	X		X			10
H.R. 1104; Hinson; 1-22-81	X	X			X	X		10
H.R. 2950; Rangel; 4-1-81		X	X					5
H.R. 2965; Nowak; 4-1-81		X	X		X			10
S. 1240; Heinz-Riegle; 5-20-81	X	X	X		X	X		
H.R. 3824; Kemp (with Garcia, et al.); 6-4-81 (S. 1310, companion)	X	X	X	X	X	X	X	20
Administration's proposal announced 3-23-82 (S. 2298 and H.R. 6009)	X	X	X	X		X	X	24

SUMMARIES OF SELECTED GAO REPORTS ON FEDERAL ECONOMIC DEVELOPMENT AND JOB CREATION ACTIVITIES

Review of Economic Opportunity Programs (B-130515, Mar. 18, 1969)

GAO's review of the Office of Economic Opportunity (OEO) antipoverty programs covered a broad range of Federal activities costing $1.8 billion in 1968, including local Community Action Programs; manpower programs such as the Job Corps, the Concentrated Employment Program, the Work Experience and Training Program, and the Neighborhood Youth Corps Program; health programs; education programs, and the other programs such as the Small Business Economic Opportunity Loan Program. Principal GAO review findings concerning the programs included:

--Effective program coordination was not being achieved with existing organizational structure.

--Manpower (job training and job placement) program results were limited in terms of enhancing participants' capabilities, subsequent employment prospects, and future earnings. Most programs experienced high early dropout rates for participants.

--Most program and project managers were not provided adequate guidance and monitoring by OEO and other Federal agencies. Consequently, activities such as screening and selecting program participants needed much improvement.

--Virtually all programs needed to strengthen controls against financial irregularities, especially in payroll procedures.

Improvements Needed in Federal Agency Coordination and Participation in the Model Cities Program (B-171500, Jan. 14, 1972)

GAO examined the policies and procedures which HUD and other Federal agencies established to coordinate Federal financing and technical assistance of the Model Cities Program. GAO observed that the program's success depended to a great degree on the continuous support of, funding of, and staffing by participating Federal agencies. GAO noted, however, that HUD and other Federal agencies often had not agreed on the appropriate levels of Federal funding and staffing commitments necessary to accomplish program goals. Further, the roles of HUD and other agencies were not agreed upon, particularly the responsibilities for reviewing, approving, and administering Model Cities plans and programs.

Economic Development Programs in Bedford-Stuyvesant, Brooklyn, New York, Under the Special Impact Program (B-130515, Aug. 20, 1973)

GAO undertook this review to determine how OEO's Special Impact Programs in housing, job creation and job training, and business attraction affected the Bedford-Stuyvesant community. GAO observed that after more than 5 years of Federal funding totaling more than $30 million, the program had a visible but limited impact on the community. Although the program created some jobs through a comprehensive manpower program, initiated new development, renovated existing housing, made loans to local businesses, and provided area community facilities, it fell short of its goals in developing minority-owned businesses and attracting new industries to the area to create jobs for residents. Moreover, GAO concluded that even if all the sponsors had substantially met program goals, it is doubtful that the program would have had more than a minimal impact on the area's problems, as the community's economic problems were deep seated and resisted rapid solution.

Job Training Programs Need More Effective Management (HRD-78-96, July 7, 1978)

GAO reviewed the effectiveness of classroom training and on-the-job training conducted under title I of the CETA act. GAO audited the program's impact on participants and the effectiveness of Department of Labor and prime sponsor (generally, State and local government) monitoring and program evaluation. GAO's sample of over 2,000 classroom training participants showed that 49 percent obtained jobs after completing training but many obtained jobs not related to the training received. Further, only about 32 percent of the sample found employment and retained their jobs for at least 6 months. Another GAO sample of 800 on-the-job training program participants showed that 58 percent completed training and were retained by their employers, but only about 38 percent stayed with their training employer 6 months after training. Many participants who left training or their job were still unemployed--generally 6 months after they left the program. GAO attributed the program's limited success to such factors as the sponsors' inability to assess applicants' aptitudes and employability. Furthermore, GAO recognized that the success of training programs might be affected by factors beyond the sponsors' controls such as the motivation of individuals and the economic conditions of the sponsors' areas. GAO concluded that stronger and more active Federal oversight is needed for the job training program to ensure that Federal dollars are spent more effectively.

Job Corps Should Strengthen Eligibility Requirements and Fully Disclose Performance (HRD-79-60, July 9, 1979)

GAO's review of the effectiveness of the Job Corps program activities identified problems in the program's recruiting process as well as in its preparation and reporting of job placement information. In addition, it questioned the program's long-term economic impact on economically disadvantaged youths. GAO reported that Job Corps eligibility criteria were so broad that eligibility determinations on participants were not very meaningful and they precluded the need to consider alternative programs. GAO also found that Job Corps recruiters did not have sufficient information to fully inform youths on the program, nor did they have the incentive to refer youths to consider alternatives. Further, the youths' interests and aptitudes were seldom determined and used in assigning youths to program centers and training.

GAO also noted that the reliability of Job Corps placement rates was questionable and the rates did not provide the Congress with adequate information to assess program effectiveness. Further, GAO concluded that little is known about how well more than half a million youths have done in the labor market after participating in the Job Corps. While a sample of participant earnings data indicated program graduates earned more than nongraduates, only 27 percent of the participants had graduated. Further, GAO's analysis of pre- and postprogram earnings indicated that many graduates, as well as nongraduates, did not earn enough to break the poverty cycle.

More Can Be Done To Ensure That Industrial Parks Create New Jobs (CED-81-7, Dec. 2, 1980)

GAO reviewed the Economic Development Administration's program of funding industrial parks to attract industry and create jobs in depressed areas. The report concluded that a number of park projects had not attracted businesses, were not well-utilized, and did not create as many jobs as planned. GAO suggested that these problems were, in part, caused by the agency's failure to perform park feasibility studies on new projects and, as a result, many marginal parks were funded. GAO also noted that nearly 46 percent of businesses located in the parks were business relocations, which were against general Federal policy.

OTHER REFERENCE MATERIALS USED IN PREPARING THIS REPORT

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"Criteria for Participation in the Urban Development Action Grant Program Should Be Refined" (CED-80-80, Mar. 20, 1980).

"Information on the Buildup in Public Service Jobs" (HRD-78-57, Mar. 6, 1978). See p. 22 for a discussion on the extent of ineligible CETA program participants.

"Investment Tax Credit: Unresolved Issues" (PAD-78-40, May 8, 1978).

"Tax Expenditures: A Primer" (PAD-80-26, 1979)

Congressional Budget Office reports

"CETA Reauthorization Issues" (Aug. 1978). See pp. 53 and 54 for a discussion of the eligibility verification issue.

"Employment Subsidies and Employment Tax Credits" (Apr. 1977).

"Tax Expenditures: Current Issues and Five-Year Budget Projections for Fiscal Years 1981-1985," a Report to the Senate and House Committees on the Budget--Part III (Apr. 1980). See pp. 1-3 for an explanation of tax expenditures.

Congressional Research Service reports

"Small Business Taxation, Capital Formation, and Innovation" (Oct. 31, 1980).

"Youth Unemployment and the Federal Minimum Wage" (Sep. 21, 1981, update).

Other documents

"Enterprise Zones: A Land Banking Approach," The Urban Institute (Sept. 24, 1981, statement).

"Enterprise Zones and the Corporate Income Tax," The Urban Institute (Nov. 1981).

"Enterprise Zones: Greenlining the Inner Cities," Stuart M. Butler (1981).

"The Implementation of the Targeted Jobs Tax Credit" (Report Nos. 1 and 2), prepared for the United States Department of Labor Office of Program Evaluation, Employment and Training Administration (July 1980 and Jan. 1981).

"Putting the Targeted Jobs Tax Credit Back to Work," Northeast-Midwest Institute (Sept. 1980).

Testimony of John E. Chapoton, Assistant Secretary for Tax Policy, United States Department of the Treasury, concerning Federal tax credits for employment, before the Subcommittee on Economic Growth, Employment and Revenue Sharing, Senate Committee on Finance (Apr. 3, 1981).

ORGANIZATIONS INTERVIEWED OR CONTACTED

DURING THIS REVIEW

Advisory Commission on Intergovernmental Relations

American Federation of Labor and Congress of Industrial Organizations

American Legislative Exchange Council

American Planning Association

British Embassy (Commercial Department)

Brookings Institution

Chamber of Commerce of the United States

City of Cleveland (Office of the Mayor)

Council for Northeast Economic Action

Government of the District of Columbia (Office of Business and Economic Development)

Greater Baltimore Committee (Enterprise Zone Subcommittee)

Heritage Foundation

National Association of Manufacturers

National Association of Wholesalers-Distributors

National Federation of Independent Business

National Governors' Association

National League of Cities

National Low Income Housing Coalition

Northeast-Midwest Institute

Sabre Foundation

U.S. Conference of Mayors

Urban Institute

Urban Research and Strategy Center

EXECUTIVE OFFICE OF THE PRESIDENT
OFFICE OF MANAGEMENT AND BUDGET
WASHINGTON, D.C. 20503

MAY 24 1982

William J. Anderson
Director, General Government Division
United States General Accounting Office
Washington, D.C. 20548

Dear Mr. Anderson:

The Director has asked me to respond to your letter of April 23, 1982, requesting the view of the Administration on the GAO draft report "Enterprise Zones as an Approach to Revitalizing Distressed Areas: Many Uncertainties Exist."

In general, the Administration agrees with the report that many questions do exist with respect to the Enterprise Zone approach to urban revitalization. As with any innovative approach to social problems, this is not unusual. The questions the draft report raises are legitimate questions and were fully considered in formulating the Administration's Enterprise Zone proposal. Because there are several lingering questions which will not be fully answered until this approach is tried and evaluated, the Administration has proposed that this approach be implemented on an experimental basis, as the draft GAO report also recommends.

Years of direct Federal intervention through numerous categorical development programs have not successfully revitalized our distressed urban areas. To a large degree, the desired effects were limited, often short-lived, and fell far short of their goals. Aware of the failure of these previous, well-meaning efforts and realizing that only the private sector can effectively create and sustain economic growth and jobs, President Reagan announced his Enterprise Zone proposal. Not only an innovative approach to urban revitalization, Enterprise Zones represent a significant and long overdue shift in Federal policy. On an experimental basis, some of our nation's most distressed areas will be "greenlined" with current impediments to free market economic activity removed, taxes and regulations reduced, and employment incentives provided. Unlike previous Federal efforts, heavy handed Federal prescriptiveness and intervention will not be present. The Administration believes that once freed of existing barriers the private market will respond and urban revitalization will occur in these areas.

Though the Administration is in general agreement with the draft GAO report insofar as the report raises legitimate questions about the Enterprise Zone concept, several specific comments need to be made.

The Need to Evaluate the Effectiveness of the Enterprise Zone Approach

The Administration agrees with the GAO draft report that an effective research design and program effectiveness criteria must be established. However, legislatively mandating in detail the type of research design or the criteria to be used would not be advisable since, once underway, a change to the research design or the criteria being used may be needed.

Moreover, HUD's Office of Policy Development and Research (PD&R) is already preparing to analyze and evaluate the effectiveness of the Enterprise Zone approach with reports to Congress and the Administration. Among the urban development impacts to be addressed will be the net revenue gain or loss to the Treasury, the benefits realized by the zones, their cities, and their unemployed, and the effect of zones on surrounding areas. In addition, PD&R will assist HUD in formulating and revising the selection process to choose the most promising applicants and in evaluating various local and State experiments in the Enterprise Zone approach.

An effective strategy is now being devised by PD&R to permit short-, intermediate-, and long-term evaluation. To achieve this objective, a base line will be developed for each designated zone prior to going into operation, followed by progress evaluations after the first three to six months (short-term), one and a half years (intermediate-term) and three years (long-term). Biennial reports are anticipated thereafter.

Percentage Hiring Requirement for the Disadvantaged

The Administration opposes a hiring requirement for disadvantaged workers as a prerequisite to receiving Federal Enterprise Zone tax incentives. The overall intent of the Administration's proposed Enterprise Zone legislation is to reduce Federal regulations and prescriptiveness and allow for free-market, private sector expansion. A hiring requirement would impose unnecessary Federal prescriptiveness, require burdensome monitoring, and discourage certain businesses, especially small ones, from entering Enterprise Zones. If applied only to firms above a certain size, the enforcement of a hiring requirement would become even more burdensome and complex. The Administration, having considered this possibility, believes that the cost of any hiring requirement would not clearly be exceeded by the benefits that might be realized.

Furthermore, the Enterprise Zone tax credit for disadvantaged workers is sufficiently different than previous tax incentives which have had only limited success. The Targeted Jobs Tax Credit, to which GAO draws a comparison, provides a tax credit of 50 percent of the first $6,000 in the first year, 25 percent in the second year, and nothing in the third year. By contrast, the Administration's proposed Enterprise Zone legislation would provide for a 50 percent credit for all wages paid by employers to disadvantaged workers for the first three years of employment, with a graduated phase-out thereafter. This is a powerful tax credit which should strongly encourage the hiring of low-income, disadvantaged individuals. Certainly before imposing a hiring requirement, this new approach should be tried in order to ascertain its effectiveness.

Determining Eligibility for Wage Credits

The Administration strongly supports State or local determination and verification of worker eligibility for wage credits. States and localities, through the use of designated local agencies, are just as competent as the Federal Government in determining and verifying worker eligibility for wage credits. In fact, they may be more qualified because of their greater proximity to and knowledge of the workers and their greater accountability to the workers and businesses in the zones, as well as to their locality and State.

The Effect of the Economic Recovery Tax Act of 1981 (ERTA)

ERTA reduced marginal tax rates on personal income from all sources, and this doubtlessly will increase amounts of labor and saving forthcoming at any set of market wages and interest rates. In this sense, wage and interest costs that must be recovered in market prices of goods and services will be generally reduced, or, as is popularly described, the "effective tax rate wedge" will be reduced. Similarly, the accelerated cost recovery system and enhancement of the investment tax credit (ITC) provided in ERTA have generally reduced the cost of acquiring and using depreciable assets. These changes will produce costs of capital services to be recovered in selling prices of output equivalent to those that would prevail if the tax rate on capital income of this sort were near zero.

Tax incentives targeted for Enterprise Zones that have been proposed by the Administration differentially reduce labor and capital costs for zone activities. The zone employers' and employees' credits reduce labor costs as compared with those costs outside the zones by as much as 15 percent. The additional zone ITC reduces costs of acquiring and using depreciable property by approximately 5 to 10 percent, depending on the type of property. Moreover, these differential Federal tax incentives are additive to the differential cost reductions that will be available only in zones as a result of reduced State and local tax burdens and of reductions in the stringency of Federal, State, and local regulation of economic activity.

Attracting Small Businesses

It is important to recognize that the Enterprise Zone initiative is not just a Federal tax incentive program. The program involves an across-the-board effort to remove all types of government burdens on economic activity.

Regulatory relief will help small businesses since regulations impose costs which businesses must bear regardless of whether they make a profit. Such relief will be particularly important to small businesses. Large businesses can generally absorb the costs of regulations more easily, by such means as spreading the costs imposed over more units of production, and are also better able to pass the imposed costs on to customers. Small businesses do not have these advantages.

Improved local services, through the introduction of competition and private sector providers, will also help small businesses. Such improved services will allow businesses to operate more efficiently and lower their costs. State and local reduction of taxes (e.g., property and sales taxes) which apply regardless of profitability will also help small businesses.

Many of the Federal tax incentives will help small businesses also. The capital gains elimination will help small entrepreneurs who start and build up new businesses to receive the full value of their effort when they sell out. The provisions for the continuation of industrial development bonds in Enterprise Zones will help small businesses obtain start-up capital. This particular incentive does not rely on the tax liability of the small businesses but on the liability of its lender, and consequently it should be effective in aiding small businesses. The extension of the operating loss carryover and the carryover of unused Enterprise Zone credits will allow small businesses which are successful to eventually receive the benefit of the zone incentives. The abatement of tariffs and import duties through the designation of Foreign Trade Zones in Enterprise Zones will also help small businesses, since these taxes are again borne regardless of the profitability of the firm.

Tax relief in general should also help to encourage the establishment of small businesses in Enterprise Zones. All small entrepreneurs start businesses expecting to make a profit sometime within a 20 year period, which is the time for which an Enterprise Zone may last. The tax relief will increase this expected profit, and therefore should induce more small businesses to start in Enterprise Zones.

In addition, the Enterprise Zone incentives will encourage large businesses to locate branches within the zones. These branches will provide business opportunities for small, spin-off firms.

Residential Displacement

The Administration's Enterprise Zone program will make every reasonable effort to minimize involuntary displacement while improving the chances of zone residents to work their way into the mainstream of the economy. The program was specifically designed to help low-income, disadvantaged zone residents participate in the zone's economic success through, for example, the Federal tax incentive to hire low-income, disadvantaged people and the establishment of "Neighborhood Enterprise Associations."

In addition to minimizing any involuntary residential displacement, two important aspects of the Administration's plan are intended to improve the residential situation of zone residents. First, the investment tax credit for Enterprise Zone property provides an incentive for the private construction and rehabilitation of rental housing units, thereby providing more adequate housing units, not fewer, for the zone residents. Second, by bringing the disadvantaged zone residents into the mainstream of the economy, they will better be able to improve their standards of living and demand more and better housing.

APPENDIX V

The Possibility of Business Relocation

The Enterprise Zone program is designed to avoid luring businesses away from their current locations. In fact, relocation of existing businesses is actually quite uncommon. Picking up and moving a business is expensive, disruptive, and unpopular with workers and management alike.

The purpose of the Administration's Enterprise Zone program is to foster new births and expansions of firms and businesses in declining areas, not to cannibalize other communities. The intent behind the program is to stimulate the creation of entirely new business activity within the zones that would not have otherwise occurred at all. This will be accomplished by reducing government burdens on economic activity within the zones. This will increase the return for successful business activity within the zones, stimulating the creation of new businesses.

It is quite possible that some entrepreneurs considering the establishment of entirely new businesses and some existing firms considering major expansions will locate their new facilities within the zones, even though they would have gone ahead with these projects elsewhere in the absence of the program. While relocation in this sense is not as purely beneficial as the stimulation of entirely new activity, bringing such economic development to the Nation's distressed areas has important social benefits and would, therefore, still be an advantageous result of the program.

Weakening Businesses Outside the Zones

The economically distressed areas eligible for Enterprise Zone designation generally have a much higher cost of doing business than other areas. The effect of the Enterprise Zone incentives will be to offset these higher costs, leaving the Enterprise Zone firms on a relatively equal footing with firms elsewhere. If the incentives more than compensate for these higher costs, then land values within the zones would tend to rise to offset this advantage. The end result, therefore, would be to bring the zones into the mainstream of the economy.

Firms just outside the zone should in fact be substantially benefited if the program is successful. Firms are usually better off if they are on the edge of an economically successful area than if they are on the edge of an economically distressed area.

Favoring New Businesses Moving into the Zones Over Existing Ones

Existing businesses enjoy practically the same tax benefits as do new or relocating businesses. These tax benefits include investment tax credits, the 50 percent tax credits for hiring disadvantaged workers, and the capital gains exclusion. Employee tax credits apply equally to workers in new and existing businesses. The only real difference is that existing businesses must expand their workforce to benefit from the basic 10 percent employer tax credit based on wages paid. This is designed to avoid giving a windfall to existing businesses as well as to encourage business expansion.

The Employee Wage Credit

The employee wage credit in the Administration's proposed legislation is designed to be oriented toward the lower income worker while providing some encouragement to all persons to work in an Enterprise Zone. Even though some low-income workers may not benefit fully because of insufficient tax liability initially, the credit applies for the life of the zone, so these persons most likely will receive wage increases and eventually benefit from this credit. Treasury estimates that more than 90 percent of this tax credit will be taken by full-time workers.

Regulatory Relief to be Provided

The legislative language with respect to Federal regulatory relief is intentionally non-specific in order to permit local and State governments to exercise maximum initiative in this regard. Rather than prescribe specific areas, regulatory relief can be tailored to the particular conditions in the zones, except regulations statutorily required or those affecting civil rights, safety, and health, including environmental health.

Other Federal Program Support for Enterprise Zones

The Administration's Enterprise Zone proposal provides for consultation by the Secretary of HUD, who is responsible for the zone selection and implementation, with the Secretaries of Agriculture, Commerce, Labor, and Treasury, the Office of Management and Budget, and the Small Business Administration. In addition, the Secretary of HUD is required by the proposed legislation to coordinate HUD programs in Enterprise Zones. While the proposed legislation does not require targeting Federal programs in Enterprise Zones, their application in Enterprise Zones by local and State officials (as with Community Development Block Grant funds) is very likely and would be a prudent use of such funds by their recipients.

I trust these comments will prove useful to you in finalizing this important report. In turn, I hope the report stimulates debate and interest in the Enterprise Zone approach to urban revitalization, resulting in speedy passage of our Enterprise Zone proposal.

Sincerely,

Annelise Anderson

Annelise Anderson
Associate Director for
Economics and Government

(384802)

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