THE RATIONALE FOR ENTERPRISE ZONES

Peter J. Ferrara

Federal, state and local governments have spent literally hundreds of billions of dollars in the past two decades to solve the nation's urban problems. Yet these problems are now far worse than when these efforts began. It is merely to state the obvious to say that these efforts, taken collectively, have not been successful in achieving their broadest goal of urban revitalization.

In the past few years, support has been building for an entirely new approach towards solving these problems – enterprise zones. The Reagan administration has now proposed the establishment of an Enterprise Zone program at the national level, which Congress is currently considering. This paper will examine the rationale for the program.

The Enterprise Zone Concept

The basic concept behind enterprise zones is to create an open, free-market environment in the nation's depressed inner cities and rural towns through the removal of taxes, regulations, and other government burdens on economic activity. The creation of this environment and the removal of these burdens would then create and expand economic opportunity within the zone areas leading to the economic revitalization of these areas and to real, private-sector jobs for workers in or near those areas.

The model for enterprise zones is the free-trade zones established throughout the world, such as Hong Kong. Within these zones, gov-

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ernment intervention into the private market economy has been kept to an absolute minimum. As a result, rapid and substantial growth has generally been stimulated, improving the standard of living for the population of these areas far beyond the population in the surrounding areas.

Enterprise zones are thus based on an entirely fresh paradigm of thought concerning economic growth and distressed areas. The old approach was based on two elements – subsidy and central planning. This involved taxing away part of the hard-earned income of workers and producers to give subsidies to others in need, maintaining or increasing their economic dependency. It also involved massively bureaucratic urban renewal projects and other central planning tools aimed at redirecting existing economic activity.

The new approach is instead based on market processes and the creation of new economic wealth. Instead of subsidies, it focuses on removing government barriers to economic growth, barriers which are preventing people from creating, producing, and earning their own wages and profits. The idea is to focus on what the government is doing that inhibits economic growth, that prevents people from achieving the kinds of things they want. And instead of central planning, the new approach seeks to create a general climate of open markets where entrepreneurs and economic activity can flourish, relying on market forces to determine the course of redevelopment within the zones.

It is important to emphasize that the concept is based on creating a process or climate – a free market – rather than on achieving particular results or goals. Thus, the concept does not involve an attempt to stimulate a specific kind of business – large or small, labor-intensive or capital-intensive, industrial or commercial, etc. Instead, it seeks to roll back government burdens across the board and let the market decide what activities should take place in the zones. This market-process orientation is based on the view that the establishment of a free market is the best means for achieving prosperity and full employment, and that the government is quite unlikely to be successful in aiming at particular, discrete results through any actions beyond this.

The enterprise zone concept builds on the recognition that there is a wealth of latent, underutilized talent and opportunity within the nation's economically depressed urban and rural areas. The idea is to lift the government-imposed "lid" off these areas and allow them to flower. Through the removal of government burdens and the reestablishment of natural incentives, the intent is to stimulate the creation of new businesses and jobs that would not have existed in the

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absence of the program and not to try to induce outside businesses to relocate in the zones. Therefore, the program is not an attempt to reverse current economic trends, but to give distressed areas the maximum flexibility to adapt to these trends through building on existing talents and opportunities within enterprise zones.

The enterprise zone concept involves not just removing taxes and regulations within the zone areas, but also attempting to solve problems and provide services through increased reliance on decentralized, voluntary, private, market institutions rather than highly centralized, bureaucratic, government institutions. An additional category of government barriers to economic growth is inadequate municipal services, which the government has monopolized and thereby foreclosed to alternative providers. Enterprise zones should, therefore, include privatization – relying on alternative, private-sector firms and institutions to provide these services where feasible. It should also involve utilization of private, local, neighborhood and community organizations to facilitate participation by zone residents in the economic development of the zone areas and to help deal with social problems in those areas.

The basic concept of enterprise zones indicates that in their pure form they should not involve any government appropriations or expenditures. Such appropriations were characteristic of the old approach of providing direct subsidies, rather than the new Enterprise Zone approach of removing government burdens.

The Rationale for Enterprise Zones

The rationale for enterprise zones is most fundamentally based on the view that economic growth can be sustained over the long run only by reliance on free markets and the private sector. Such growth cannot be sustained through centralized government regulations or subsidies. Therefore, the way to revive the depressed inner cities and rural towns of the nation is to reestablish reliance on private markets and institutions within these areas.

On a simple microeconomic level, the removal of government burdens would reduce the cost of doing business within the zones. The lack of economic activity within these areas now suggests that ultimately the cost of doing business there is greater than elsewhere in the nation. If the reduction of costs involved in the program is great enough, the cost of doing business within these areas would be brought down to national levels, making them economically viable again.

This analysis indicates that enterprise zones can be the solution to economic decay, even if the government burdens they remove are not the major cause of such decay. The resulting reduction of costs can still bring the cost of doing business down to viable levels, even if these costs were abnormally high for some other reason.

But it should also be noted that the mere fact that the same government burdens generally apply across the nation does not mean that those burdens are not the cause of economic distress within particular areas. It may simply be that the economic base of these particular areas is weaker than elsewhere and they cannot stand the weight of these burdens, while other areas can continue to prosper even under this weight.

One cannot discuss the rationale for enterprise zones without discussing the work of Dr. Stuart Butler who, with characteristic brilliance, has further refined this rationale. Butler in particular develops two broad arguments which suggest that the general free-market climate of the zones should be particularly effective in stimulating urban revitalization.[1]

The first point builds on the work of Professor David Birch of MIT.[2] Birch recently conducted the most comprehensive study of private-sector employment ever undertaken. This study examined employment over the period 1969-1976 at 5.6 million firms, representing 80 percent of all private-sector employment.

The clear conclusion of this study was that small firms of 20 employees or less were the primary job generators nationwide. These firms accounted for 66 percent of all net, new private-sector jobs across the country in the period under study. In the Northeast, these firms accounted for virtually all net, new private jobs.

Birch also found that the reason that some areas of the country were booming while others were declining was not relocation of existing businesses. Less than one percent of all the employment changes Birch found were due to such relocation. The study also found that the reason for these differences was not higher rates of business failure or contraction in depressed areas. The rate of job loss due to such failures or contractions was found to be relatively uniform across the country. It was in fact found to be higher in some of the most rapid growth cities, such as Houston.

Birch found instead that the reason for growth of some areas and the decline of others is that the birth rate of new firms and jobs was

[1]See Stuart M. Butler, *Enterprise Zones: Greenlining the Inner Cities* (New York: Universe Books, 1981), and idem, *Enterprise Zones: Pioneering the Inner City* (Washington, D.C.: Heritage Foundation, 1980).

[2]See David Birch, *The Job Generation Process*, M.I.T. Program on Neighborhood and Regional Change, 1979, pp. 19–20; idem, *Job Creation in Cities* (Cambridge, Mass.: MIT Press, 1980).

so much greater in the growing areas than in the declining ones. The high birth rate of new jobs more than offset the loss of jobs in Houston, so that on net the city was growing, while the low birth rate in New York failed to offset its normal job loss, so on net the city was declining.

Butler deduces from these findings that the key to inner-city job creation is to establish an overall climate attractive to entrepreneurs able to start new small businesses – a climate suitable to risk-taking and experimentation. Butler argues that it is particularly difficult to stimulate such entrepreneurial activity through traditional, centralized, government aid programs, citing Birch in support:

> The job generating firm tends to be small. It tends to be dynamic, (or unstable, depending on your viewpoint) – the kind of firm that banks feel very uncomfortable about. It tends to be young. In short, the firms that can and do generate the most jobs are the ones most difficult to reach through conventional policy initiatives. . . . The very spirit that gives them their vitality and job generating powers is the same spirit that makes them unpromising partners for the development administrator.[3]

Butler concludes that open, free-market climates to be established by enterprise zones will be the most conducive to the establishment of new businesses by small entrepreneurs.

The second broad argument developed by Butler builds on the work of Jane Jacobs. In her seminal book, *The Death and Life of Great American Cities*,[4] Jacobs advanced the thesis that the key to strong and vibrant inner-city neighborhoods is diversity. The neighborhood must be used by different people for different purposes at different times – housing, shopping, working, playing, etc. – so that there will always be a significant public presence in the streets. This will deter crime and contribute to a vibrant community spirit. This in turn means that mixed-use activities must be allowed within each neighborhood. There also must be a mixture of old and new buildings, providing the posh settings suitable for large, established firms and the bargain opportunities suitable for small, new, struggling firms. There must be room and opportunity for the complex bonds that bind a community together – economic, social, religious, familial – to develop and grow.

Butler argues that many traditional urban revitalization efforts have been unsuccessful because they have failed to recognize – indeed they have contributed to the destruction of – the indigenous diversity

[3]Birch, *The Job Generation Process*, pp. 17, 20.

[4]See Jane Jacobs, *The Death and Life of Great American Cities* (New York: Random House, 1961).

and community bonds necessary for viable inner-city neighborhoods. Large-scale construction projects, for example, have destroyed existing inner-city networks and replaced them with masses of individually unconnected residents or businesses unintegrated into the local economy. The free-market climate of enterprise zones, by contrast, should build upon existing inner-city networks and institutions, and indeed contribute to additional diversity. The removal of stultifying uniformity through zoning and unnecessary occupational licensure laws, for example, will aid the development of diversity in neighborhoods.

Yet it is not only because enterprise zones are likely to be successful in urban revitalization that they should be adopted. From a free-market perspective, it is also that they will accomplish this goal by a particular means – an *increase in economic liberty* that will contribute to the overall establishment of free markets.

Other important advantages of the program relate to political rather than substantive factors. The creation of islands of economic freedom in America's major central cities will hopefully serve as useful demonstrations of the success of free markets. This should lead to pressures for further economic liberalization nationwide. The deregulation, the tax reductions, the privatization involved in the Enterprise Zone program would then hopefully expand across the country.

Enterprise zones have already performed a great service as a pedagogical device. The broad discussion of the possible establishment of the federal program has already caused state and local officials to begin to reexamine their local policies, to begin to look at the burdens they place on economic activity, instead of just the subsidies they might provide. This advantage of the program is likely to become even more important in the future.

Moreover, for those who wish to advance the cause of economic liberty, the program can serve as a platform to appeal to political interest groups, which up until now have been hostile. Through enterprise zones, free-market partisans can show minority group members and inner-city residents that capitalism can work for them. This could change attitudes not only with regard to this program but to issues across the board. The progam can therefore be used as the basis for an appeal for general support from these groups for economic liberalization. For long-term success, free-market partisans need to make such appeals to all segments of the population.

Finally, it should be noted that simply not addressing the problem of inner-city deterioration and urban decay is not a viable political option. In the current political climate, there must be some program addressed to the needs of economically distressed areas. From a free-market perspective, it is far better to address this political need through enterprise zones than through typical grant programs.

Compared with these benefits, the cost of the Enterprise Zone program is relatively low. Since it is a no-appropriations program, it does not involve increased government expenditures. The tax-relief portion of the program may entail costs in terms of forgone revenue. But the other elements of the program—deregulation, improvements in local service through privatization, and involvement of private-sector neighborhood organizations—should not entail costs in any terms.

Even the cost of the tax relief is likely to be quite modest. Since enterprise zones are to be placed in economically depressed areas, there is little existing economic activity in potential zone sites. Consequently, revenue losses from the reduction of taxes on such activity would be small. If outside businesses moved into the zone, revenue losses from zone tax cuts would increase. As is discussed below, however, such relocation is likely to be insignificant. Entrepreneurs planning to start wholly new businesses or expand existing ones might choose to locate these facilities within a zone, though they would have gone ahead with them elsewhere in the absence of the program. But offsetting the revenue losses from such actions would be new tax revenue resulting from businesses and jobs that would not have been established, inside or outside of the zone, without the program. Such losses would also be offset by the employment of workers who would otherwise be unemployed, particularly those who would otherwise be receiving government aid.

Conceivably, these offsetting factors could outweigh the losses, making enterprise zones net revenue producers. In return for their tax cuts contributed to the zones, cities could reclaim revenues from the additional business activity generated by the incentives at the federal, state, and local levels. In the area of the property tax, for example, substantial improvement in the zone economy would improve property values throughout the zone, resulting in increased property tax revenues. Depending on how great any reduction in zone property tax rates is, it is easy to see that in many cases the end result would be increased property tax revenues on net. Whether this net revenue increase is beneficial depends on what actions the government takes in response to it.

Our theoretical analysis is supported by the U.S. Treasury's estimates of the federal revenue losses resulting from the Reagan administration's proposed Enterprise Zone program. The Treasury Department estimates that the losses would be $12.4 million per year per zone, and approximately $300 million for 25 zones. These estimates were based on the conservative assumptions that some new businesses would choose to locate in the zones which would have located elsewhere without the program, and that virtually no new activity would be stimulated that would not have occurred elsewhere. The estimates were for a tax package that would reduce federal business income taxation by 75 percent or more, eliminate all capital gain taxes, abate tariffs and import duties, and provide tax cuts for zone employees.

Criticisms

Despite this analysis of the costs and benefits, gnawing concerns over enterprise zones do exist from a free-market perspective. One of these is expressed in the often asked question: Why limit the free-market climate to be established by the program to the small zone areas; why not make the whole country into one big enterprise zone?

The answer from free-market advocates of enterprise zones is that they would like to establish the zone environment thoughout the nation, but that is politically impossible at the moment. A political opportunity exists to begin the process in certain depressed areas of the country, so why not seize it?

There is a reason for special urgency for economic liberalization in potential enterprise zone areas since these areas, as we have suggested, simply may not have a strong enough economic base to survive economically under the weight of government burdens, though other areas may still manage under such burdens. If enterprise zones would work in reviving economically depressed areas, would it make sense to delay this implementation and let these areas continue to suffer? To argue that the zone advantages should not be implemented until they could apply to all areas is like arguing that one should not prevent the torture of only one of two innocent victims unless he could also prevent the torture of the other.

A more substantial concern from a free-market perspective is the potential for relocation of business activity resulting from enterprise zones. As we have noted, it is unlikely that existing businesses would choose to relocate in the zone areas in response to the zone incentives. Existing businesses locate where they are for a reason, and they tend to be adapted to the clientele and opportunities of that location. Moreover, the costs of relocation are usually substantial. The business community has almost unanimously confirmed that such relocation is unlikely. Nevertheless, the potential for relocation exists. More likely is the possibility that some entrepreneurs considering the establishment of entirely new businesses, and some existing firms considering major expansion, would locate their new facilities in the zones, even though they would have gone ahead with these projects elsewhere in the absence of the program.

From a pure free-market perspective, relocation in either of these two senses is a negative. Such relocation means that the market process has been distorted, that businesses are not locating on the most efficient sites. This leads to an important conclusion – one cannot unequivocally state that from a free-market perspective enterprise zones are a good idea, as we can say, for example, that rent decontrol is a good idea. Support for enterprise zones by free-market adherents has to be based on a judgment that, on net, the advantages of the program outweigh the disadvantages.

It should be easy to see, however, that from the free-market view the program is on net clearly beneficial. This can best be seen by analogy. The likelihood of relocation due to enterprise zones is really not any greater than the likelihood of relocation due to President Reagan's general economic program. The nationwide tax cuts and deregulation are likely to stimulate some relocation of businesses from other countries to the United States. Such relocation will clearly distort the market process internationally, again causing businesses not to locate on the most efficient sites, and leading to a reduction of total wealth created worldwide. Should free-market advocates have argued against the tax cuts and deregulation until they could be implemented worldwide because of this resulting distortion and inefficiency? One might argue that since such relocation was entirely from outside the United States, from the U.S. perspective it is not a negative. But from the view of the objective public policy analyst committed to free markets, such relocation should be just as much of a problem as the relocation resulting from enterprise zones. One should not be confused by the fiction of political boundaries.

Or to take a cleaner example, consider the case of Rhode Island or the District of Columbia. Strong state and local tax cuts and deregulation within those states hold the same potential for relocation as enterprise zones. Should free-market adherents within or outside these jurisdictions oppose these policies until all states, or all countries, could be induced to implement them? Clearly not.

Finally, consider a remote possibility. After years of ingenious litigation, the Indians win a Supreme Court case giving them back the island of Manhattan. At the same time, the tribal council is attending a seminar co-sponsored by the Center for Libertarian Studies and the Institute for Humane Studies, and they are convinced by the old curmudgeon, Murray Rothbard, that an unfettered free market is the ideal system. They therefore eliminate virtually all taxes and regulations, completely privatize public services, and use volunteer community action to care for the needy. Would this development be bad from a free-market perspective because of the potential for relocation onto the island? Clearly not.

A final concern is whether enterprise zones are the most efficient means for stimulating urban revitalization, or whether direct expenditure programs might be more controllable and efficient. The concern here is that the cost per new job created, in terms of forgone revenue under enterprise zones, may be greater than the cost per new job created in terms of dollars spent under direct expenditure programs.

There is no model that can tell us the cost per job created by enterprise zones, nor is there likely to be, and such estimates for other programs are generally spurious. Therefore, there is certainly no basis for such comparisons between the two types of programs at the present time.

Moreover, any such comparison would be much like comparing apples and oranges. First of all, enterprise zones hold the potential for creating jobs and income that would not have existed elsewhere in the absence of the program. Enterprise zones hold the potential for increasing the total wealth of the economy. The jobs and income produced by direct expenditure programs can be ascribed to relocation since the same dollar's worth of resources spent in one area of the economy is drawn out of another area through taxation.

The tax and regulatory reductions involved in enterprise zones merely allow businessmen to keep more of what they have produced and earned in the first place. In order to receive a "subsidy" provided through such relief, a business must first produce and earn income at least equal to the value of the subsidy. There is therefore no redistribution. Through direct expenditure programs, however, the production and earnings of some are taxed away and redistributed to the beneficiaries who have not produced or earned them through productive effort evaluated in the marketplace. Because of this key philosophical difference, the incentives provided through enterprise zones may be preferable to the subsidies provided through expenditure programs, even if the "cost per job" of the former is greater than the latter.

This feature of the enterprise zone incentives also implies greater efficiency in one sense than the subsidies provided through expenditure programs. Since in order to receive any benefit under enterprise zones a business must first produce and earn some income, there is a natural, decentralized market test for the program's subsidies. They will not go to firms that are not at least somewhat viable in the marketplace. Direct expenditure subsidies can, by contrast, go to firms that are completely without viability on their own.

Conclusion

More than government expenditures and subsidies, residents of economically depressed areas need opportunities. This is the focus of the Enterprise Zone program. The program will identify and remove government barriers to entrepreneurs, which can create jobs and economic growth. It will spark the latent talents and abilities already in existence in our nation's most depressed areas. This bold new concept deserves to be given a chance to work.