

# MERCATUS CENTER

## George Mason University

### Written Testimony of

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Madam Chairwoman, Vice Chair Walters, and members of the Committee, thank you very much for inviting me to testify on the reauthorization of California's Enterprise Zone program. I regret that I am unable to join you in Sacramento today, but I hope that my written comments will be useful to your deliberations.

California's Enterprise Zone (EZ) program is the largest targeted economic development program in the state. Since beginning in 1986, 42 zones have been established. The intent of the EZ program is to bring economic development to high-poverty or distressed geographical areas.

To receive EZ designation, a city must meet certain eligibility criteria (measured by the level of poverty, income, unemployment, or crime) and apply to the Department of Housing and Community Development. Zone designation depends on the quality of a city's application and economic development plan, which indicates how the city plans to administer and promote the EZ program.

Numerous studies have been conducted evaluating the effectiveness of California's EZ program. Recent studies by Kolko and Neumark (2010)<sup>2</sup> and Elvery (2007)<sup>3</sup> both report that California's EZ program has not increased employment in the zones. Kolko and Neumark further find the EZs did not generate increases in jobs or businesses.

These studies are part of a 25-year base of literature evaluating zone performance in the United States. Largely econometric, most studies debate the techniques and data used to evaluate zones. On balance, the empirical evidence suggests that zone policy itself should be revisited as a tool for promoting economic development. Enterprise Zone policies have had limited to no effect on job creation and business growth in targeted areas.

I will discuss the premise of the EZ program and suggest an alternative for policymakers to consider.

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<sup>1</sup> The views expressed in this testimony are solely my own and are not official positions of the Mercatus Center or of George Mason University.

<sup>2</sup> Jed Kolko and David Neumark, "Do Some Enterprise Zones Create Jobs?" *Journal of Policy Analysis and Management*, Vol. 29, No. 1 5-38, 2010.

<sup>3</sup> Joel A. Elvery, "The Impact of Enterprise Zones on Resident Employment: An Evaluation of the Enterprise Zone Programs of California and Florida," *Economic Development Quarterly*, Vol. 23, No.1 (44-59) 2009.

The idea behind the California Enterprise Zone program is that, by offering tax breaks to businesses in geographic areas meeting certain poverty criteria, jobs will be created for low-skilled workers, generating economic growth and revitalization.

The weak results of Enterprise Zone policies and programs, point to a fundamental flaw with this approach. Using targeted tax breaks to benefit particular businesses in eligible areas may in fact be a barrier to producing the intended outcomes: Entrepreneurship and economic growth. This is because EZ policy is based on an incomplete view of the conditions necessary to encouraging economic growth.

### **EZs erect barriers around economic activity**

EZ's are designed to encourage business growth. Yet EZs place an artificial geographic boundary around entrepreneurial activity,<sup>4</sup> and then a further boundary around the types of activities and business that are eligible for credits. It may be that a neighboring city contains start-up businesses that are hampered from expanding due to high taxation or regulatory barriers, and that these businesses are equally likely to employ a disadvantaged person living inside of a zone. This is one reason why some evaluations advocate extending credits to businesses outside of EZs, or redrawing lines. These recommendations acknowledge that by erecting a geographic boundary, some businesses are disadvantaged in their tax treatment.

Another way EZs erect barriers is by using incentives to promote specific business activity. Tax incentives create an uneven playing field and encourage short-term planning by firms. Incentives are not the equivalent of a broadly applied tax cut, which is more stable and neutral.

By giving benefits to some at the expense of others, tax breaks end up picking winners (even unintentionally) and produce unforeseen consequences.

Even well-designed credits may in execution have very different effects than those envisioned by their designers. For example, EZ credits may be more appealing to certain types of industries, or they may tend to favor capital over labor. Peters and Fisher (2002) find that in California the rubber and plastic firms tend to face lower tax rates than printing and publishing and “it is doubtful that these differences are the desired outcome – the result of deliberate policy.” The difference has to do with the variation in the structures of these industries: The mix of capital and labor they employ, their profitability, their asset structure.<sup>5</sup>

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<sup>4</sup> Kolko and Neumark find “the recent emphasis on local strategies, highlights the fact that economic development administrators and policymakers may have a good deal of scope for decisions affecting the locations of enterprise zones and how they are implemented and administered – emphasizing why it is important to better understand the potential for these decisions to influence the effectiveness of enterprise zones.” Jed Kolko and David Neumark, “Do Some Enterprise Zones Create Jobs?” *Journal of Policy Analysis and Management*, Vol. 29, No.1 (5-38) (2010) pp. 9-10.

<sup>5</sup> Peters and Fisher state, “The variation in effective tax rates is due primarily to differences among industries in terms of profitability, asset composition, and the relative importance of capital and labor, and to differences among localities in terms of, the make-up of the property tax base, the nature of tax incentives. More profitable firms are at more of a disadvantage in cities in which state (and occasionally local) taxes on corporate profits predominate. The relative importance of inventory, plant, and equipment in the firm’s asset structure can be very important; firms with a high proportion of real property (buildings and land) are disadvantaged in places with high property-tax rates or no abatements, while firms with substantial inventory are disadvantaged by states that subject inventories to the property tax. More capital-intensive industries are advantaged by incentives tied to capital investment, while more labor-intensive industries are advantaged by incentives tied to job creation.” Alan H. Peters and Peter S. Fisher,

The result is that those businesses benefiting from tax incentives may not be the businesses most needed or valued in a particular community or by society, just those that were eligible and able to benefit from the credit. Additionally, the credit may act as an unintentional subsidy, reducing state revenues while not creating new jobs or economic development.

The largest credit – the hiring credit – inadvertently benefits only those businesses that are aware of the program and have the need for low-skilled workers. By targeting credits to workers meeting specific criteria, the program may further encourage the mismatching of skills and jobs, and it may shut individuals out of employment.

Eligibility criteria encourage gamesmanship and what economists call rent-seeking, the pursuit of income through political rather than economic means. Because geographic areas and businesses are only eligible if they meet certain criteria, the planning aspect of selecting zones and qualifying for credits may encourage gamesmanship. This means that planning officials can exert their preferences, which may run counter to what is actually demanded in that community.<sup>6</sup> The EZ model has created an industry dedicating to helping people and businesses navigate the system. EZs have their own interest groups that profit from the program. This leads to another critique: The businesses most able to take advantage of credits are those with sufficient resources to be aware of the program, navigate the application process, and comply with the criteria. Small and family-owned businesses may end up “slipping through the cracks.”

## **Recommendations**

The EZ program has failed to produce the hoped for benefits of economic revitalization and robust economic growth. The reason is the policy is discriminatory and introduces complexity and gamesmanship into the tax code and business decisions. EZ policy fails to consider the larger institutional environment: The state’s overall tax system, regulations, and other factors that may hamper economic activity. By targeting certain areas and businesses, EZs attempt to plan economic development. Instead, the state should set rules that encourage entrepreneurship without regard to firm size or business activity.

To create an environment that encourages business growth and job creation, California should institute policies that establish a predictable and stable economic environment and create a tax system that is neutral and general with respect to business activity. Exemptions and exceptions should be eliminated. A predictable, general, and stable tax environment enables a wider variety of businesses to enter the market and to establish deeper roots. Simplifying the tax system by removing exemptions and broadening the tax base also contributes to a more efficient and stable tax system for the state, and leading to less volatility in revenue collection.

**California should adopt a broad-based and low rate tax system when possible.** A broad-based, low rate system should reduce and remove exceptions and exemptions. By broadening the base, the state may

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*State Enterprise Zone Programs: Have They Worked?* W.E. Upjohn Institute for Employment Research, Kalamazoo, Michigan (2002), p. 86.

<sup>6</sup> Kolko and Neumark appear to identify the potential for gamesmanship and “chasing the credit” in their evaluation. They find that EZ program have a more favorable impact in zones where managers report doing more marketing and outreach activities. However, “a strong focus on helping firms pursue hiring credits made available by the EZ program appears to run counter to job-creation efforts. These findings have potentially important policy implications for targeting areas to designate as EZs and for features of EZ programs that policymakers and administrators encourage via both legislation and the selection of sites as EZs.” Jed Kolko and David Neumark, “Do Some Enterprise Zones Create Jobs?” *Journal of Policy Analysis and Management* 29(1), 2010, p. 7.

lower the rate of tax, which will stimulate more business growth and hiring, while bringing in revenues. Taxation should be neutral with respect to business activity and not attempt to pick winners by giving more favorable treatment to some industries or locations.

**Legislators should identify and, if appropriate, reform regulatory barriers.** Policies that aim to stimulate economic activity in distressed areas should assess what barriers exist to entrepreneurship on the local level, such as excessive land use and business regulations and high local taxes or fees.

**Understand how social policies and economic policies interact.** Policies that stabilize social environments will help to encourage business formation, and thus create jobs. This includes policies that reduce crime and improve educational outcomes.

The job of government in economic development is to set and enforce the rules of the game. As it applies to taxation and regulation, this means establishing clear and easy to follow rules that do not discriminate between industries or geographies. Tax breaks (or refunds) create an arbitrary and uncertain economic environment that makes it difficult for businesses to plan into the future. Instead, California should create a tax environment that is stable, and general, and one that encourages entrepreneurship.

Instead of establishing EZs, California policymakers should review the economic environment with a view towards eliminating barriers to entry in the California economy. Local governments should do the same. Each city and community faces its own particular set of barriers to development and prospects for revitalization.