

Enterprise Zones as a Means Of Reducing Structural Unemployment

By Stuart E. Weiner

Unemployment in the United States remains undesirably high despite a sharp decline from its recession peak in late 1982. Much of this unemployment is structural in nature, unrelated to the overall strength of the economy. Structurally unemployed individuals are unemployed not because of insufficient aggregate demand, but because of imperfections in labor markets. As such, broad monetary and fiscal policies can have only limited corrective impact; narrower, more targeted policies are needed.

One possible method for reducing structural unemployment is to establish "enterprise zones" in selected depressed inner city areas. Firms operating in such zones would receive tax benefits as well as regulatory concessions. If successful, these tax and regulatory incentives would generate business activity in the zones which, in turn, would lead to lower unemployment.

Originally developed in Great Britain, the enterprise zone concept has sparked considerable interest in the United States. Twenty-one states have passed enterprise zone legislation, and nine have programs in place. At the national level, the Reagan administration has

introduced enterprise zone legislation in each of the last two years. In his recent State of the Union address, the President again urged Congress to "help us to free enterprise by permitting debate and voting 'yes' on our proposal for enterprise zones in America." He went on to say that "its passage can help high-unemployment areas by creating jobs and restoring neighborhoods."

This article evaluates the potential impact of enterprise zones on structural unemployment. The analysis suggests that enterprise zones would reduce structural unemployment. Enterprise zones are no panacea, however, and other programs, more universal in application, could have an equal or greater corrective impact. A comparison of enterprise zones with alternative policies is beyond the scope of this article.

The first section of the article provides an overview of structural unemployment. The distinction is drawn between cyclical and structural unemployment, and various types of structural unemployment are reviewed. The second section describes the enterprise zone concept, emphasizing the administration proposal. Employment incentives, capital incentives, and provisions for regulatory flexibility are surveyed. The third section of the article explores the potential effectiveness of enterprise zones in reducing structural unemployment.

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ment. Included are a discussion of possible sources of new business activity and a brief preliminary report on existing British and U.S. state programs. Finally, the fourth section offers a summary and concluding remarks.

The problem of structural unemployment

There are two major types of unemployment: cyclical and structural. Cyclical unemployment occurs when there is a general downturn in the economy. Consumer and business spending declines, inventories accumulate, production falls, and workers are laid off. Structural unemployment, on the other hand, occurs even when the economy is operating at full strength. Structural unemployment reflects imperfections in labor markets, imperfections that exist regardless of the overall state of the economy.

Structurally unemployed individuals may be unemployed for a variety of reasons. They may have the wrong skills, live in the wrong areas, face institutional barriers, be inefficient in job search, or have little incentive to accept the jobs they are offered. Each of these five primary sources of structural unemployment is examined in this section. While it is difficult to know exactly how much unemployment is structurally based, unemployment in the 6 to 7 percent range is probably at present a good estimate. A portion of this unemployment may be regarded as beneficial, but a good portion of it clearly is not. Consequently, structural unemployment is of some concern.

One source of structural unemployment is the mismatch between the skills possessed by available workers and the skills required for available jobs. Job openings and unemployed individuals can coexist because the individuals do not have the requisite qualifications for the jobs. New entrants into the labor force, reentrants into the labor force, and workers dis-

placed from dying industries often confront this type of unemployment. So too do chronically low-skilled individuals who for one reason or another never acquire the skills that would widen their employment opportunities.

A comparison of unemployment rates across broad occupational groups gives a rough indication of skill mismatch unemployment. In the recovery year of 1979, for example, the unemployment rate among white collar professional and technical workers was 2.4 percent, while the rate among low-skilled manual laborers was 10.8 percent.¹ Professional and technical workers had little difficulty finding employment in the robust economy. Manual laborers, in contrast, had considerable difficulty. Despite general prosperity in the economy, such individuals faced high unemployment because their limited skills failed to match the needs of prospective employers.

Skill mismatch unemployment would decline if available workers were better educated and better trained. Consequently, any policies that furthered those ends would serve as partial remedies to the structural unemployment problem. Better elementary and secondary educational programs, of course, would constitute a basic first step. In addition, vocational training loan programs, similar in design to present college loan programs, could be instituted to assist low and middle income youths in acquiring training at technical schools. Wage subsidy programs designed to encourage on-the-job training would perhaps be even more effective in augmenting the skills of the labor force.

A second source of structural unemployment is the mismatch between the location of available jobs and the location of available workers. Locational mismatch unemployment

¹ From Table 35, *Handbook of Labor Statistics*, Bulletin 2070, Bureau of Labor Statistics, Washington, D.C., December 1980.

can be said to exist when job seekers living in a given location could qualify for existing vacancies in another location.

Locational mismatch can arise when one region of the country grows more quickly than another. One example that has received considerable publicity in recent years is the movement of jobs and people to the Sunbelt. Rapid industrial growth in the South and Southwest has come in part at the expense of the Northeast and Midwest, with the result that some of the unemployment in the latter two regions is locationally derived. Potential remedies for regional locational mismatch unemployment include worker relocation subsidies and an extensive and more efficient national employment service.

Another type of locational mismatch may be termed intrametropolitan mismatch, or the mismatch of workers and jobs in the same metropolitan area. Intrametropolitan mismatch occurs when vacancies exist in the suburbs but available workers in the central city are unable to reach them, either because of high commuting costs or because such individuals do not learn about the vacancies due to high search costs or distance-related deterioration of job information flows. This issue also has come to the fore in recent years. Firms have increasingly abandoned central cities for sites in surrounding suburbs, with a possible adverse impact on the employment prospects of inner-city residents.

There are no statistics on the extent of suburbanization nationwide. However, changing patterns in the Kansas City metropolitan area may be representative. In 1970, Jackson and Wyandotte counties, the counties containing the central cities of Kansas City, Missouri, and Kansas City, Kansas, respectively, accounted for 77.5 percent of all jobs in the six-county area. By 1980, this share had fallen to 69.3 percent. Johnson County, an area of

rapidly growing suburbs, exhibited the opposite pattern; its share of metropolitan employment increased from 10.1 percent to 17.8 percent.²

Unemployment rates diverge widely within a metropolitan area. Chart 1 presents central city and suburban unemployment rates for the nation as a whole during the years 1973 through 1982.³ As indicated, central city residents have experienced higher unemployment rates than suburban residents throughout the 10-year period. More striking differences emerge when one compares particularly distressed inner-city areas with particularly affluent suburban areas. In the Kansas City area in 1980, for example, unemployment rates of 15 percent and higher were common in the inner city, while rates of 1 and 2 percent were prevailing in certain parts of the suburban fringe.⁴

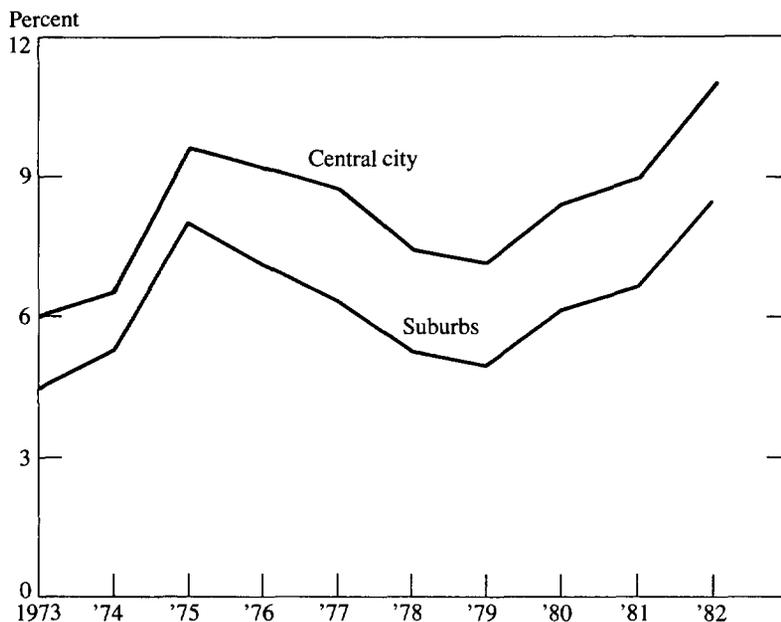
Intrametropolitan mismatch of workers and jobs is probably one factor underlying the divergence of local unemployment rates. One must be mindful, however, of obvious biases. A disproportionate number of inner-city residents are low skilled or receive public transfer payments. Both factors increase the probability of unemployment, irrespective of any loca-

² Reflecting this suburbanization of business, 88.8 percent of the workers living in Jackson County in 1970 worked in Jackson County, while only 2.6 percent worked in Johnson County. By 1980, 84.6 percent worked in Jackson County and 5.9 percent worked in Johnson County. Correspondingly, 41.2 percent of the workers living in Johnson County in 1970 worked in Jackson County, while 43.1 percent worked in Johnson County. By 1980, 29.8 percent worked in Jackson County and 56.5 percent worked in Johnson County. Statistics have been derived from 1970 and 1980 Census data.

³ From Table B-4, *Labor Force Statistics Derived from the Current Population Survey: A Databook*, Volume 1, Bulletin 2096, Bureau of Labor Statistics, Washington, D.C., September 1982, and Table 57, *Employment and Earnings*, Bureau of Labor Statistics, Washington, D.C., January 1983.

⁴ From Table P-10, *1980 Census of Population and Housing, Census Tracts, Kansas City, Mo.-Kan. SMSA*, PHC80-2-200, Bureau of the Census, July 1983.

CHART 1
Intrametropolitan unemployment rates in the United States
 (Adults 16 and over)



tional mismatch. Suburban residents, in contrast, are disproportionately high-skilled, which decreases the probability of their being unemployed. In addition, many suburban residents commute to jobs in central business districts. The favorable employment standing of these individuals clearly does not reflect their closer residential proximity to jobs.

It is not clear how serious intrametropolitan mismatch is, that is, how binding locational constraints (commuting costs, search costs, information flow deterioration) are in practice. Studies indicate that workers are very mobile and that few individuals, including inner-city residents, work near their homes.⁵ Of greater interest, however, is the unobserved mobility of nonworkers, specifically low-income inner-city nonworkers who would like to be

working. For such individuals, as firms migrate from inner cities to suburbs, commuting costs and search costs unambiguously increase and job information flows likely deteriorate. Suburbanization of business would appear to leave inner-city job seekers in a worse position.

One possible solution to intrametropolitan locational mismatch is to encourage firms to stay in inner-city areas. Alternatively, rapid transit routes from the inner city to surround-

⁵ See, for example, Sheldon Danziger and Michael Weinstein, "Employment Location and Wage Rates of Poverty-Area Residents," *Journal of Urban Economics*, April 1976, pp. 127-145, and David T. Ellwood, "The Spatial Mismatch Hypothesis: Are There Teenage Jobs Missing in the Ghetto?" NBER Working Paper No. 1188, August 1983.

ing suburbs could be improved.

A third source of structural unemployment is the existence of institutional barriers. Various laws and social practices prevent labor markets from working as efficiently as possible. Minimum wage laws, union membership restrictions, and racial and sexual discrimination provide three examples.

Minimum wage laws, despite their good intentions, have a deleterious impact on the employment prospects of low-skilled, low-wage individuals. Wages are not permitted to fall below an artificial floor even when market conditions dictate such a decline. Consequently, wages are higher than they otherwise would be, causing employers to hire fewer workers and causing more individuals to enter the labor force. The net result is an excess supply of low-skilled, low-wage individuals, which increases unemployment. Were wages free to settle at market-clearing levels, unemployment among such individuals would decline.

Union membership restrictions are another type of institutional barrier. Individuals excluded for one reason or another from joining a union are unable to work at union shops and unable to take advantage of union training programs. Such restrictions reduce employment opportunities, both now and in the future. Racial and sexual discrimination in hiring has a similar impact. Qualified individuals are shut out of potential positions, losing valuable on-the-job training in the process. Like minimum wage laws and union membership restrictions, discriminatory hiring obstructs the smooth functioning of labor markets.

The remedy for unemployment resulting from institutional barriers is, of course, to remove the barriers. Abolishing minimum wage laws, banning union membership restrictions, and prohibiting discriminatory hiring would eliminate a significant amount of struc-

tural unemployment.

A fourth source of structural unemployment is imperfect information flows. Job vacancies may exist but go unfilled simply because job seekers are unaware of the vacancies.

Individuals can search for employment in a number of ways. They can apply directly to employers, place and answer classified ads, use public and private employment agencies, and exchange information through word of mouth. Some methods of job search may not be as efficient as others. Sole reliance on public employment agencies, for example, may be ineffective because of a large number of applicants per vacancy. Alternatively, some methods of job search may be inefficient for certain groups only. For example, word of mouth is likely to be ineffective for inner-city residents because a large percentage of such individuals' peers are unemployed.

Establishing a more efficient and extensive public employment service would be one way to improve the flow of information to job seekers. Beyond that, however, policy options appear limited. It is difficult, and perhaps undesirable, to develop measures that would influence how individuals search for work.

A final source of structural unemployment relates to the disincentives associated with various public transfer programs. An individual receiving unemployment compensation or welfare payments has little incentive to search for or accept a job paying only a marginally higher income. Public transfer payments clearly serve a useful purpose in providing some measure of income security to individuals facing adversity. However, they also tend to lengthen the duration of unemployment spells.

Several proposals have been made for reducing this type of structural unemployment. Suggestions range from reducing benefit levels or eligibility to establishing a voucher system

in which transfer payment recipients could in effect buy employment from employers. The issue continues to generate a good deal of research and a great deal of debate.

While all structural unemployment inherently reflects imperfections in labor markets, some structural unemployment may nevertheless be beneficial from a personal standpoint. When an individual quits a job to look for a better one or enters the labor force for the first time, the time spent in job search represents in part an investment in the future. (This unemployment is structural because if job information networks were perfect, job search would be unnecessary.) For example, an individual entering the labor force from college would probably not want to accept the first job offered. Instead, the new entrant would want to “shop around,” talking to a number of potential employers and weighing the alternatives. In a world of imperfect, sequential information, such a strategy is optimal.⁶

Society also profits from this extended job search. The better matched workers and jobs are, the more productive workers will be. From a societal as well as a personal standpoint, therefore, some structural unemployment is beneficial.⁷ Unfortunately, much structural unemployment is clearly nonbeneficial. It is to this type of unemployment that enterprise zones are directed.

The enterprise zone concept

Enterprise zones were conceived by Peter Hall, a professor of geography and urban planning at the University of Reading in Great Britain. In a 1977 address to the British Royal

⁶ Robert J. Gordon develops this argument in *Macroeconomics*, 2nd ed., Little, Brown and Co., Boston, 1981, pp. 312-314.

⁷ This component of structural unemployment is sometimes referred to as “frictional” unemployment.

Town Planning Institute, Hall proposed establishing “freeports” in severely depressed areas of Britain in order to encourage entrepreneurial activity. These freeports would be zones of “fairly shameless free enterprise,” where all British tax laws, social services, and industrial regulation would be suspended. Wage and price controls, including minimum wage laws, would be eliminated, and all goods could be imported and sold duty-free. As Hall explained:

This is essentially an essay in non-plan. Small, selected areas of inner cities would be simply thrown open to all kinds of initiative, with minimal control. In other words, we would aim to recreate the Hong Kong of the 1950s and 1960s inside inner Liverpool or inner Glasgow.⁸

Hall regarded the freeport proposal as an “extremely drastic last-ditch solution,” and recommended that it be attempted on a very small scale. He felt that “it is most appropriate to those inner-city areas which are largely abandoned, and denuded of people, or alternatively, areas with very grave social and economic problems.”⁹

Hall’s freeport proposal sparked the interest of Sir Geoffrey Howe, a leading member of the Conservative Party and then Shadow Chancellor of the Exchequer. Howe offered a more restrained version of the proposal in a speech in 1978. It was in this speech that he coined the term “enterprise zone.” When the Conservative Party, led by Margaret Thatcher, came to power in 1979, Howe moved into the office of the Chancellor of the Exchequer. He announced detailed plans for an enterprise

⁸ Peter Hall, “Enterprise Zones: A Justification,” *International Journal of Urban and Regional Research*, September 1982, p. 417

⁹ Hall, p. 417.

zone program in his March 1980 budget address. By late 1981, 11 zones were in operation. Thirteen additional zones were authorized in 1982.

The British enterprise zone program is seen as being essentially experimental. It is not regarded as part of the government's regional policy, nor has it replaced any existing programs. Enterprise zones, the first 11 of which range in size from 140 to 1,100 acres, are so designated for ten years. They enjoy the following primary benefits: (1) exemption from the development land tax, i.e., exemption from capital gains taxes on increases in land value; (2) exemption from "general rates," i.e., exemption from local property taxes on industrial and commercial property, with local governments being reimbursed by the central government; (3) 100 percent deductibility of capital expenditures on the construction, extension, or improvement of industrial and commercial buildings against corporation or income tax liabilities; (4) simplification of planning procedures — developments that conform to general guidelines do not require individual approval; and (5) reduction of governmental requests for statistical information. As evident from the list, enterprise zone provisions offer major incentives to developers and firms to operate in the zones. However, they fall far short of the sweeping deregulation originally proposed by Hall.

The enterprise zone concept was introduced into the United States by Stuart Butler, a Heritage Foundation policy analyst who became aware of the idea while visiting Great Britain in 1978. Butler promoted the idea in numerous publications, and politicians soon took notice. Enterprise zone legislation first appeared in 1979, in the Illinois legislature. National legislation was introduced in 1980 by Representative Jack Kemp. With Representative Robert Garcia as a cosponsor, Kemp reintroduced the

bill later that year and again the following year.¹⁰ The Reagan administration formally embraced enterprise zones in 1982 by introducing a bill of its own. The bill was approved by the Senate Finance Committee but was not acted upon in the House. The administration submitted a slightly revised version of the bill in 1983; it again cleared the Senate Finance Committee and also received a committee hearing in the House.¹¹ As the President emphasized in his recent State of the Union address, passage of the bill remains a legislative priority of the administration in 1984.

The administration's enterprise zone proposal has as its twin goals the creation of jobs in depressed areas and the physical redevelopment of these areas. These goals are to be accomplished through various tax and regulatory incentives made available to businesses locating in the zones. Like the British government, the Reagan administration regards its proposed program as experimental. Under the bill, termed the Enterprise Zone Employment and Development Act of 1983, the Secretary of Housing and Urban Development would designate up to 75 areas as enterprise zones over a three-year period.¹² A designation would remain in force for 20 years, followed by a four-year phaseout. To qualify as a potential enterprise zone, an area would have to meet certain economic demographic, and physi-

¹⁰ David Hardison provides a detailed political history of U.S. enterprise zone legislation through 1981 in *From Ideology to Incrementalism*, Princeton Urban and Regional Research Center, Princeton University, 1981.

¹¹ Forty-three senators cosponsored the bill in the Senate (S.863), and 242 representatives cosponsored the bill in the House (H.R.1955).

¹² Unlike the 1982 bill, the 1983 bill requires that 25 zones be located in rural areas. The analysis in this article is strictly applicable to urban enterprise zones only; however, several of the issues raised hold for rural zones as well.

cal criteria. Areas would be nominated by local governments in conjunction with their states. Major provisions of the proposed program are as follows:

(1) A general payroll tax credit for employers increasing net employment in the zones, equal to 10 percent of each additional employee's wages up to \$17,500, or \$1,750 per employee.¹³ The credit is nonrefundable — amounts in excess of current tax liabilities would have to be carried forward for use in later years;

(2) A nonrefundable special tax credit for employers hiring "disadvantaged" individuals in the zones (welfare recipients, general assistance recipients, and others poverty stricken), equal to 50 percent of the employee's wages, with no upper limit;

(3) A nonrefundable tax credit for employees working in the zones, equal to 5 percent of the employee's wages up to \$10,500, or \$525;¹⁴

(4) A nonrefundable 3 or 5 percent investment tax credit, over and above the regular investment tax credit, on capital investment in the zones, and a 10 percent credit for the construction or reconstruction of buildings;

(5) Elimination of all long-term capital gains taxes on business property in the zones;

(6) Preservation in the zones of the use of tax-exempt small-issue industrial development bonds, currently scheduled to sunset at the end of 1985;

(7) Increased regulatory flexibility in the zones, whereby federal agencies and regulatory bodies could relax, upon request of state and local authorities, any regulatory requirements except requirements provided by statute or affecting civil rights, safety, or public health; and

(8) A requirement that state and local governments commit themselves to specific actions to enhance development of the zones, including perhaps tax and regulatory relief, improved services, and community involvement.

The administration's enterprise zone proposal differs in several ways from the British program. The most important difference is that it provides explicit employment incentives in addition to capital and development incentives. Another notable difference is that the U.S. proposal does not call for a federally financed elimination of local property taxes.

Enterprise zones have received considerable attention at the state level as well. Twenty-one states have passed enterprise zone legislation, and nine — Kansas, Missouri, Illinois, Louisiana, Kentucky, Ohio, Florida, Maryland, and Connecticut — have programs in place. Provisions vary from state to state, but all are in keeping with the general aim of the enterprise zone concept: to encourage business activity in severely depressed areas with the intent of creating jobs and lowering unemployment. The next section assesses the likelihood of meeting these goals.

¹³ The income eligibility limit would vary over time, equaling 2.5 times the FUTA (Federal Unemployment Tax Act) wage base (presently \$7,000).

¹⁴ The income eligibility limit would vary over time, equaling 1.5 times the FUTA wage base.

Will enterprise zones reduce structural unemployment?

Enterprise zone legislation seeks to create jobs in depressed inner-city areas. Although such legislation is explicitly aimed at bringing jobs to available workers in the hope of reducing intrametropolitan locational mismatch unemployment, other types of structural unemployment may be reduced as well. In this section, the potential effectiveness of enterprise zones in reducing all forms of structural unemployment is examined. The analysis focuses on the administration proposal.

If enterprise zones are to be successful in lowering structural unemployment, they must first generate new business activity in the zones. Accordingly, this section opens with an evaluation of the likely sources of new activity. In the second subsection, the key issue is addressed: What types of structural unemployment would new activity likely reduce? The section closes with a brief review of early experience under existing British and U.S. state programs.

Sources of new activity

Enterprise zones can attract new business in three different ways: through the in-migration of outside firms, the birth of new firms, or the expansion of existing firms. The provisions of the administration proposal appear to favor the third.

Studies indicate that, although relocations are well publicized, few firms actually relocate, and those that do rarely do so for tax purposes. Factors more often cited by execu-

tives as being influential in relocation decisions include low land costs, favorable labor climate, proximity to markets, access to transportation, and "economies of agglomeration," or the presence of other firms in the area.¹⁵ Although lower taxes are obviously desirable, they do not appear to be an overriding concern.

These results suggest that the tax incentives offered in the administration proposal might not be successful in getting firms to relocate to zone areas. Such an outcome would not necessarily be cause for concern, however. Unless relocating firms expanded their workforce upon arrival, migration of firms into enterprise zones would merely represent a transfer of activity from one area to another. If previously existing vacancies were filled, however, or if other firms were induced to expand operations in the zones because of growing economies of agglomeration, migration of existing firms would on net be beneficial.

Enterprise zone proponents look to the birth of new firms and the expansion of existing firms as more important potential sources of new activity. A research group at MIT has found that virtually none of the employment change in an area is due to firms migrating in or out.¹⁶ Instead, most of the change reflects firm birth and expansion relative to firm death and contraction.

Virtually all enterprise zone initiatives in the United States, including the administration proposal, have emphasized the desirability of providing an environment in which new small businesses could thrive. This policy goal in part derives from studies which indicate that small businesses contribute more than their

¹⁵ Kenneth A. Small surveys several of these studies in *Geographically Differentiated Taxes and the Location of Firms*, Princeton Urban and Regional Research Center, Princeton University, 1982.

¹⁶ David L. Birch, "Who Creates Jobs?" *The Public Interest*, Fall 1981, pp. 3-14.

employment share to net employment growth.¹⁷

In its present form, however, the administration proposal would likely do little to encourage the birth of small businesses. Two factors lead to this assessment. First, all the capital and employment tax credits in the proposal are nonrefundable. Unless a firm was profitable enough to incur tax liabilities, the tax credits could not be realized. Since new small businesses tend to operate at a loss for several years, they would not benefit from the tax concessions.¹⁸ Second, except for the extension of the small issue development bond program, which tends to favor large developments, the proposal contains no financing provisions. One of the chief obstacles facing a potential entrepreneur is the need to raise capital. If the proposal included a provision for a small-business loan program or a provision allowing small-business stock purchases to be tax deductible, it would provide more impetus for the birth of new firms.¹⁹

The administration proposal would likely be successful, however, in inducing existing zone firms to expand and inducing existing nonzone

firms to open new branches in the zones. Existing firms would likely have the tax liabilities necessary to use the numerous tax credits. These credits would effectively lower capital and labor costs, making an increased level of production profitable. The regulatory concessions would also serve to lower operating costs. As production increased, employment would increase, and general activity in the zones would rise.

Because the tax credits would be geographically targeted, the possibility exists that a portion of the benefits would be capitalized in higher rent and land prices. That, of course, would temper some of the expansionary momentum. The speed and extent of capitalization would depend on a number of factors, including the rigidity of existing contractual arrangements, the relative bargaining strength of those supplying and demanding land, and the holdings of land by public authorities. Even if full capitalization eventually occurred, however, business activity would likely expand.²⁰

Since enterprise zones are not costless, there is the question of who would ultimately pay for them. Under the administration proposal, tax revenues would decline as firms and individuals utilized the employment and capital tax credits, while expenditures would

¹⁷ See Birch, and also Catherine Armington and Marjorie Odle, "Small Business — How Many Jobs?" *The Brookings Review*, Winter 1982, pp. 14-17; Catherine Armington, "Further Examination of Sources of Recent Employment Growth," unpublished mimeograph, March 1983; and Candee S. Harris, "Small Business and Job Generation: A Changing Economy or Differing Methodologies?" unpublished mimeograph, February 25, 1983.

¹⁸ Frank Swain, chief counsel for advocacy with the U.S. Small Business Administration, emphasized this point in testimony before the Senate Finance Committee. See *Enterprise Zones — 1983: Hearing Before the Committee on Finance, United States Senate*, U.S. Government Printing Office, Washington, D.C., April 22, 1983, pp. 135-151. Although nonrefundable, the tax credits could be carried forward for use in later years. Of course, this would not improve the cash flow of small firms during their early years.

¹⁹ Such provisions have been included in other enterprise zone bills. For a description of some of these bills, see *Enterprise Zones — 1983*.

²⁰ Binding rental and sales contracts, negotiated prior to the designation of the zones, would of course preclude immediate capitalization. So too would public ownership of the sites in question; rents and land prices would not be subject to profit-motivated market forces. Greater bargaining strength on the part of buyers relative to sellers (particularly in cases where the sites were previously vacant) and imperfect knowledge of the potential value of the tax credits would also temper capitalization. Even under conditions of eventual full capitalization, however, one would expect an expansion of output and employment. The effect of eventual full capitalization would be to increase fixed costs (assuming land was not a variable input); profit-maximizing output and associated input levels would therefore remain at their tax credit-induced higher levels.

remain unchanged. This implies that the federal deficit would increase. In effect, all individuals who were affected by the larger deficit, through its possible impact on interest rates or inflation, would bear the costs of enterprise zones. This is only the first-round effect, however. As business expanded in the zone areas, employment would increase, causing personal income tax revenues to rise.²¹ To the extent that newly hired employees had previously been collecting welfare or unemployment insurance, expenditures would decline. In addition, business profits might increase, further augmenting the tax base. While it is difficult to attach firm numbers to the various factors, it is clear that first-round considerations alone overstate the net budgetary impact.²²

Structural unemployment reductions

The above analysis suggests that the administration's enterprise zone proposal would induce new business activity in zone areas. This increased activity would likely cause a reduction in many types of structural unemployment.

Perhaps ironically, there is no guarantee that intrametropolitan locational mismatch unemployment would be reduced. This follows because none of the tax concessions have employee residency requirements. Firms locating in the zones would be entitled to the investment tax credit and capital gains exclusion regardless of whether they hired area residents.

²¹ Future personal income tax revenues would rise as well since newly hired individuals would acquire training and experience, making them more employable in the future.

²² The Treasury has tentatively estimated that a 75-zone program would result in a \$3.5-billion revenue loss. It is not clear, however, whether this estimate incorporates the second-round effects. See the statement by William S. McKee, acting deputy assistant secretary for tax policy, Department of the Treasury, in *Enterprise Zones — 1983*.

Likewise, firms would receive the general payroll and special disadvantaged worker tax credits regardless of where new employees lived. Although jobs might open in high unemployment areas, there is no assurance that the individuals experiencing that unemployment would benefit.

Despite this possibility, it is likely that area residents would benefit because previously existing locational constraints would be removed. Search costs would be lower because more jobs would be opening closer to home. Commuting costs would decline, making previously inaccessible job opportunities accessible. Distance-related deterioration of information flows would also diminish. All three factors would tend to reduce locational mismatch unemployment among inner-city residents.

A greater reduction in structural unemployment would likely come from the implicit toppling of the minimum wage institutional barrier. The administration's proposal in effect would allow firms to circumvent minimum wage laws. Because firms would receive general payroll and disadvantaged worker tax credits whenever they hired new employees, wages paid by employers would effectively be lowered, in some cases to below minimum wage levels. Wages received by employees, on the other hand, would be unchanged. In effect, the government would be subsidizing the wages of newly hired workers.

As noted in the previous section, minimum wage laws create an excess supply of low-skilled, low-wage individuals. The general payroll tax credit would provide an incentive for firms to hire such individuals because its income eligibility limit would effectively make the tax credit larger for low-wage workers than high-wage workers. At 10 percent, however, the tax credit would not allow large deviations from minimum wage. The disadvantaged worker tax credit, narrowly targeted on low-income, largely unskilled individuals, would permit much larger deviations, providing a subsidy of 50 percent. In circumventing

minimum wage, one important source of structural unemployment would be circumvented.

The wage subsidy provisions would also reduce skill mismatch unemployment because firms would find it profitable to hire and train workers at the now-lower effective wages. Training of general skills would be particularly enhanced. Firms usually have little incentive to train workers in general skills, as opposed to firm-specific skills, because having acquired such skills the workers can take them to other employers, leaving the original employer to absorb the training costs. If wages were subsidized over the training period, however, firms would not incur these costs. Newly hired individuals would therefore tend to acquire more on-the-job training, and their skills would be enhanced. As a result, they would be better matched to available jobs, both now and in the future.

The administration's enterprise zone proposal would also likely cause a reduction in unemployment resulting from transfer payment disincentives. Public transfer recipients would have a greater incentive to search for and accept jobs as more jobs became available at a closer distance. Search costs would decline and commuting costs would fall, making previously marginal jobs more lucrative. The employee tax credit would reinforce this incentive, although, at 5 percent, its impact would likely be small.

Finally, the increased level of business activity in zone areas would serve to reduce unemployment resulting from inefficient job information networks. Previously inefficient methods of job search would become more efficient as job information flows improved among inner-city residents. Word of mouth, for example, would become more effective, simply because there would be more vacancies to discuss. Direct application to employers would become more effective because travel time and travel costs would be reduced. In short, enterprise zones would likely have a beneficial impact on information-related

unemployment just as they would on unemployment resulting from locational mismatch, skill mismatch, minimum wage laws, and transfer payment disincentives.

British and state experience

Enterprise zone programs have already been implemented in several states in this country and in Great Britain. Preliminary results have been favorable for the former, but more mixed for the latter.

Eleven enterprise zones have been operating in Great Britain since 1981; an additional 13 have been operating since 1982. A new government-commissioned study of the first 11 zones reports that economic activity has increased in the zones, but much of this activity has been attributable to the relocation of outside firms rather than the birth of new firms.²³ Thus, although employment has increased in the zones, net job creation has been more limited. As theory would predict, rents and land values have tended to rise. The rate of development has been encouraging, but like all the early results, it is not clear how much of the improvement is due to enterprise zone incentives and how much is due to other government programs. Local governments, for example, have spent considerable sums of money developing publicly owned land.

In assessing the preliminary British results, and in particular, their possible implications for a U.S. program, two points must be made. First, the British program is very young, and one must be careful not to draw conclusions prematurely.

²³*Monitoring Enterprise Zones: Year-Three Report*, Roger Tym and Partners, London, January 1984. See also *Monitoring Enterprise Zones: Year Two Report*, Roger Tym and Partners, London, April 1983; Barbara Rosen, "U.K. Enterprise Zones Seem Successful But Depend Largely on Government Aid," *Wall Street Journal*, April 29, 1983, p. 20; Cristina Howick and Ian McDonald, "Enterprise Zones: A First-Year Progress Report," *Investors Chronicle*, September 1982, pp. ii-iii; and "Hong Kong in Wales?" *The Economist*, November 20-26, 1982, p. 61

Second, the British program differs markedly from the proposed U.S. program. The British program is designed primarily to develop abandoned land and, as such, most of its incentives are property based. It provides no direct employment incentives. The proposed U.S. program, in contrast, explicitly seeks to reduce unemployment by creating new jobs; it does provide direct employment incentives.

A recent study suggests that enterprise zones at the state level are faring well in the United States.²⁴ Nine state programs are operational, with 180 zones activated to date. Most of these zones have been in operation for less than a year. According to state and local officials surveyed, business activity has increased in nearly all the zones. A number of jobs have been created. Unlike the British experience, almost all of the increased activity has come from the expansion of existing firms and the birth of new firms. Relocation has largely been nonexistent.

But here again, the results must be interpreted with caution. The state programs are even younger than the British program, and early results could be misleading. In addition, state provisions frequently differ from the proposed national provisions, making strict comparison difficult. Like the British program, however, the state programs provide an opportunity for discovering the strengths and weaknesses of specific enterprise zone measures.

Summary

The administration's proposed enterprise zone program would likely be successful in generating business activity in depressed inner-city areas. Most of this activity would probably come from an expansion of firms already located in the zones

or the startup of new branches of multilocation firms headquartered elsewhere. Such firms would have the tax liabilities necessary to use the capital and employment tax credits. The regulatory benefits, the precise nature of which are unspecified, could serve to reinforce the incentive to expand activity in the zones.

As business activity increased in the zones, many types of structural unemployment would likely be reduced. The largest reduction would probably come from the circumvention of minimum wage laws made possible by the employment tax credits. The subsidization of wages implicit in the employment credits would also encourage more on-the-job training, which in turn would reduce present and future skill mismatch unemployment. A healthier local economy would unambiguously lower search costs and commuting costs to inner-city residents, having a beneficial impact on any existing intrametropolitan locational mismatch unemployment resulting from suburbanization of business. Unemployment resulting from public transfer payment disincentives and inefficient job information networks would also likely decline.

The proposal is not without its shortcomings, however. Because tax credits are nonrefundable and capital-raising provisions are largely absent, the proposal would do little to promote the birth of new small businesses. In addition, because enterprise zone programs by their very nature are geographically targeted, the possibility exists that some of the tax benefits could be capitalized in rent and land prices, tempering some of the expansionary incentive.

On balance, however, the enterprise zone concept has much to recommend it and, at least on an experimental basis, appears to be worth undertaking. As a narrow program designed to reduce labor market imperfections, enterprise zones are a step in the right

²⁴ *Enterprise Zone Activity in the States*, Sabre Foundation, Washington, D.C., November 1983.

direction. In addition to their beneficial short-run impact on structural unemployment, enterprise zones could help policymakers design more comprehensive future programs. In particular, by carefully monitoring the effects of the employment tax credits, policymakers could gain a better understanding of the potential benefits of a universal wage subsidy program.²⁵ Such a program, in combination with some or all of a number of other measures intended to improve the functioning of labor markets, including the elimination of minimum wage laws, a more efficient and extensive national employment service, a reduction in union membership restrictions, a reduction in discriminatory hiring, better vocational training loan programs, and better schooling in general, could go a long way in reducing structural unemployment to a desirable level. Such policies would allow the economy to move closer to a situation in which full employment was truly full employment, a situation in which minimal unemployment rates could be maintained without igniting inflationary forces.

invoked primarily as a countercyclical measure, to last only two years. For a generally favorable appraisal of its impact, see Jeffrey M. Perloff and Michael L. Wachter, "The New Jobs Tax Credit: An Evaluation of the 1977-78 Wage Subsidy Program," *American Economic Review*, May 1979, pp. 173-179. Robert Tannenwald is less enthusiastic in "Are Wage and Training Subsidies Cost Effective?—Some Evidence from the New Jobs Tax Credit," *Economic Review*, Federal Reserve Bank of Boston, September/October 1982, pp. 25-34. For a general discussion of wage subsidy programs, see Robert H. Haveman, "The Potential of Targeted Marginal Employment Subsidies," in *Marginal Employment Subsidies*, OECD, Paris, 1982.

²⁵ A geographically unrestricted wage subsidy program, the Targeted Jobs Tax Credit (TJTC) program, has been part of federal law for the past few years. Aimed at various disadvantaged groups, including welfare recipients, general assistance recipients, economically disadvantaged youth, economically disadvantaged Vietnam veterans, and economically disadvantaged ex-convicts, the TJTC program is similar in design to the disadvantaged worker tax credit contained in the administration's enterprise zone proposal. Its provisions are somewhat more modest, however. In particular, the TJTC program has a \$6,000 income eligibility limit (versus no limit in the enterprise zone proposal), and credits can be earned for two years only (versus seven years in the enterprise zone proposal). The TJTC program also appears to apply to a smaller set of individuals. The program is scheduled to continue through 1985.

The other recent experience with wage subsidies was in 1977-78, under the New Jobs Tax Credit (NJTC) program. Similar in design to the general payroll tax credit contained in the administration's enterprise zone proposal, the NJTC program granted employers tax credits for hiring additional employees. Unlike the enterprise zone proposal, however, the NJTC program was