



How California's Enterprise Zones Have Saved The State From Decline

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The purpose of this report is to provide an alternative perspective on the California Enterprise Zone (EZ) program which has been serving the state since 1984. A recent report by the California Budget Project (CBP) addresses the increasing cost of the Enterprise Zone program in California and calls attention to some of the shortcomings in the administration of the program without evaluating any of the benefits. The very title of the report, "California Enterprise Zones Miss the Mark," is an unfair and incomplete assessment of a successful economic development program for California, which, by its very success, is now being criticized for being successful. The report makes no attempt to identify the extent to which the Zones have helped make depressed areas more attractive, nor to estimate what proportion of the program costs meet the original program goals.


Considerable discussion (e.g. legislative hearings) around the state has suggested that some of the EZ program's guidelines, many of which were set twenty years ago, need revision and that some regulations no longer help the program meet its goals. The CBP report offers virtually nothing new on this account. My critique of the CBP report does not dispute that some regulations need revision. While certain provisions allowed tax credits to go to businesses claiming benefits that are no longer justifiable, I argue that the general structure of the EZ program and its goals are sound and beneficial to the state, and that the major deficiency of the CBP report is that it fails to recognize the part of the program that is and has been successful. The problems are overstated, and most are being addressed by more proactive program management and the development of regulations by the Department of Housing and Community Development.

The Critique I Offer Makes These Points

- The report fails to document the fact that the EZ program has helped save and revive many disadvantaged areas of the state by making an effective and positive contribution to California's economic development. The CBP report mistakenly claims that the problem lies in some areas which were previously struggling and are now successful.
- The report fails to document how the EZ program actually hits the mark since much of the program's costs are actually very effective economic development expenditures. The report has no basis to recommend a dramatic dwarfing of the program by substantially reducing the number of zones, limiting benefits to companies that "create new jobs," and constrict the categories of employees who qualify for vouchers.
- The CBP report is seriously out of date even as it purports to provide a current assessment of the failings of the EZ program.
- The CBP report entirely misses the point of why the California EZ program works.

Success Of The EZ Program Is Now Considered A Problem

The California Enterprise Zone Program is now about twenty years old, and the first zones are at the end of their extended period of certification. Considerable controversy remains about the impact of the EZ program because to date a definitive study has not been conducted that is able to explore the complexity of the impact of the zones on local economic development. The two most recent studies that have attempted to address the impact came to the conclusion that the EZ program has a considerable positive impact, estimating that about a third of the growth in the zones is due to the program, while the rest would have occurred anyway. No recent study has shown that the zones fail to deliver benefits. A followup study is being conducted for the Department of Housing and Community Development, but its results are not known at the present time.



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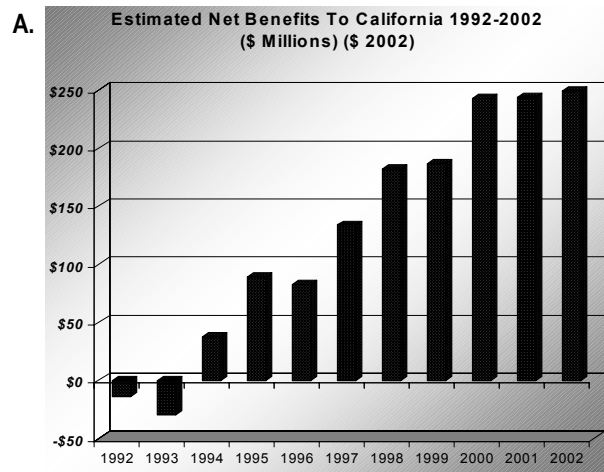
The EZ program has evolved over the twenty years since it was initiated. Zones were allowed to expand their boundaries, and the first zones were given a five-year extension. Regulations about who is eligible for hiring credits have changed, motivated in part by attempts to make the zones easier to operate and attract participants. Keep in mind that for the first decade of the program most analysts, such as Dowell, who evaluated California's EZ program suggested it was a failure for not generating any change or activity. The small amount of tax incentives claimed by firms participating in the EZ program in the first ten years of the program (from virtually none to under \$50 million in 1996) suggests that during this first half of the program's existence the challenge was to find ways to make the program active rather than insignificant. This is to be expected because many new programs have weak publicity and need start up time.

Some of the regulatory changes now being criticized were precisely those that successfully transformed the EZ program from being unknown and unsuccessful, to becoming robust, and now some would say too robust. For example, Dowell's report which is reviewed by CBP (p. 11) simply showed that until the early 1990s most firms were unaware of the EZ program and as a consequence did not utilize it. Today the CBP report suggests that too many firms are trying to utilize the program. In fact, I believe that the EZ program has achieved its goal of successfully stimulating economic development in areas that were significantly below the state in income and employment.

What We Know About EZ Success

We actually know quite a bit about the success of EZ programs, but none of that knowledge was included in the CBP report.

My 2003 report on EZs conducted with Wes Ervin at Applied Development Economics (www.adeusa.com) for the California Association of Enterprise Zones, entitled "Cost Benefit Analysis of California's Enterprise Zones" (CAEZ, 2003) is currently the most extensive study of California EZs. It is based on the most reliable data available and shows that the rate of growth in zones was about half again as fast as the rest of the state. While some of this growth would have occurred anyway, we conservatively suggested that **zones could take credit for nearly 300,000 jobs generated over a ten-year period, and that these jobs returned to the state treasury enough new taxes to pay for program costs.**



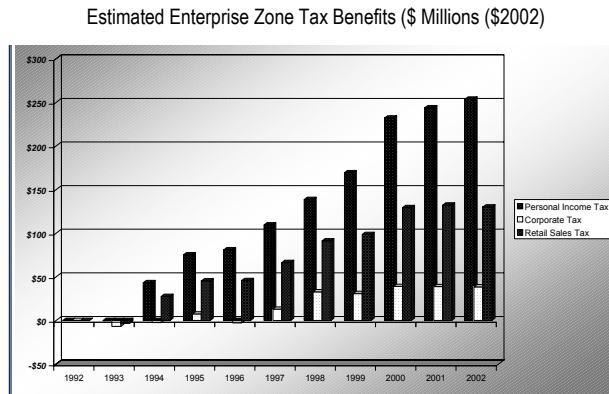
the rest of the state could not be uniquely attributed to the impact of zone incentives—the incentives were directly responsible for just a small fraction of the businesses and jobs that were created. I suggested, however, that the way the zones were selected necessitated mobilization of a collaborative effort among many economic development agencies including redevelopment, local economic development commissions, workforce development programs, business finance assistance agencies, and more. The EZ was a catalyst that focused and mobilized collective attention to economic development in a few particular areas, which had a greater impact than any incentive program alone.

To suggest that the EZ benefits were irrelevant begs the question of why employment and earnings within EZ areas grew so much faster than areas outside the EZs, since most of the other economic development programs are available statewide. Moreover, most of the area in the EZ was included because it represented the most depressed parts of the state.

The two most recent studies that have attempted to address the impact came to the conclusion that the EZ program had a considerable positive impact, estimating that about a third of the growth in the zones is due to the program, while the rest would have occurred anyway. No recent study has shown that the zones fail to deliver benefits.

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On this count, we know that the process by which zones were selected favored the most depressed communities who could put forward a case that they could successfully leverage and multiply their efforts, in spite of their difficult circumstances. The original zone selection was successful in identifying many depressed communities with the potential to utilize a new program. The fact that not all zones have achieved full development is a testimony to how difficult economic turn-arounds are.

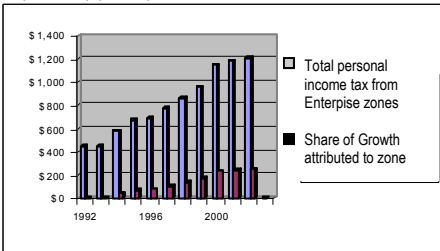


B.

Despite the fact that CBP failed to include any successful case studies of firms using EZ benefits, the CAEZ and I collected many case studies (some of which were included in the original report) showing how firms had used EZ benefits to:

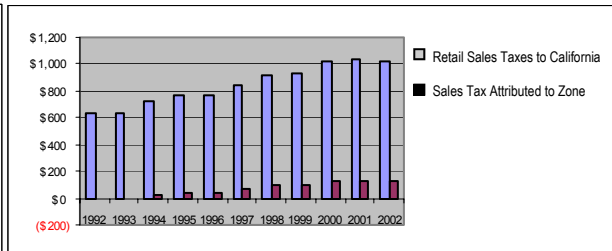
- **Stay in business or to remain where they were rather than relocate to Nevada or other competing states (retention)**
- **To innovate and redirect their firm into emerging business opportunities (expansion or transformation)**
- **To actually attract new major players through successful recruitment efforts (recruitment)**

Personal Income Tax Attributed By Enterprise Zones (\$ Million) (\$2002)



C.

Estimated Growth in Retail Sales Taxes to the State Within Enterprise Zones, 1991-2002 (\$ Million) (\$2002)



D.

The program has helped new small businesses as well as established ones, though most of the examples were for larger firms. In short, there is no evidence that the lack of documenting job growth to actual use of the incentives invalidates the results of my study or of the California Research Bureau study which provided a baseline analysis.

In addition, the CBP report criticizes my study for not estimating “the impact of state revenues lost due to EZ tax breaks on other state programs, services, and employment.” This is a silly critique. Assuming that nothing changed and the state collected additional taxes of nearly \$300 million in recent years, it is impossible to say which programs, services or government employment would have been expanded with these dollars. Moreover, the EZ program remains a tiny (though growing) part of the entire state budget. Instead, what my report successfully demonstrated is that zone stimulated growth actually generated more tax collections from the state than it cost.

Is Success A Problem?

What is worse than simply not documenting the many EZ program successes, the authors of the CBP report took some of the best examples of program success and turned them into symbols of program

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failure. For example, the CBP report criticizes San Francisco for including the Potrero Hill area in its zone. The fact that this area now has a median income of \$95,000 signifies that over the last 20 years a transformation has taken place in this part of San Francisco, helped in part by the EZ program. The whole South of Market area was a declining or abandoned factory and warehouse district much in need of revitalization at the time the zone was established, and the income in that area was not well above the average. The fact that Potrero Hill is now affluent should be seen in its historical perspective—not as a problem but a huge program success.

The failure to try to find and to document successes of the zone program leads the CBP to make some misguided policy recommendations. For example, the CBP recommendations have a consistent theme of suggesting that the state should have many fewer zones and exercise broad restriction on the use of tax credits to reduce the cost of the program. In contrast, our analysis is that a more careful evaluation of the contribution of zone credits to economic growth in depressed areas of the state would encourage revision of regulations in a way that could actually increase the program's effectiveness, perhaps even justifying an expansion of the program into new areas of the state needing revitalization.

Most Program Guidelines Actually Hit the Mark

While adjustment to regulations concerning eligibility for benefits is a continuing matter of policy debate, the CBP study makes no quantitative assessment of how substantial its critiques of individual regulations are in context of the benefit they provide. This is a very serious shortcoming. The regulations criticized in the CBP report turn on the logic that “some” benefits could be claimed by people who do not deserve them, but this is a questionable basis on which to recommend a significant reduction in the whole EZ program. The CBP report rarely documents that these problems actually lead to extensive abuses, or even to some measurable actual abuse—only the possibility of abuse. Documented below are some of the most horrendous of these CBP mistakes, but it is a general theme that the CBP wants to eliminate every benefit if there is a potential for even some misuse. Instead, a case could be made that even the most seriously criticized regulatory issues identified in the CBP report have huge benefit to the state. It is a mistake to accuse the program of “missing the mark” when it is clear that, for the most part, the program has “hit the mark.”

Targeted Employment Areas

For example, the CBP spends one whole section criticizing Targeted Employment Areas (TEAs), which are census tracts with over half of residents below the median income. From what I have been able to learn, most TEAs are indeed low income neighborhoods, and while some higher income people may live there, for the most part TEAs include people who are low income. The point here is that it is incumbent on the CBP to present data showing the balance between poor people who are legitimately vouchered from TEAs versus the higher income persons who would have found zone employment anyway. The fact that some higher income people live in a TEA and there are a few reported cases where they claimed vouchers that ideally should be targeted to low income people does not provide enough information to say that this is a gross problem. We simply do not have enough information from the CBP report to know whether the TEA criteria qualifies vouchers to go to 10 percent low income people, 50 percent low income, or 99 percent low income. Without this type of information it is irresponsible of the CBP to claim that the use of the TEA criteria for vouchering should be eliminated.

The use of census tracts to establish residency is also a broadly used means of determining eligibility for various programs. The federal government, for example, relies on residency within census tracts with high poverty levels for federal programs such as the Work Opportunity Tax Credit, and the Empowerment Zone and Renewal Community Employment Credit. The economic health of an area is impacted by the employment of residents who live in the area and earn wages to spend on other services within the area. If this criteria for zone participation works for these other programs, it is doubly important that the CBP offers a more substantial critique of the failure of this strategy to determine eligibility.

What Is A TEA?

EZs may draw TEAs to contain census tracts where 51% or more of the individuals are low to moderate income, meaning 80% of the area or countywide median.

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**California's Enterprise Zones
Expiring in 2006**

Enterprise Zone	Date of Designation	Date of Expiration
Bakersfield/Kern County	10/15/1986	10/14/2006
Calexico	10/15/1986	10/14/2006
Coachella Valley	11/11/1991	11/10/2006
Delano	12/17/1991	12/16/2006
Eureka	10/15/1986	11/14/2006
Fresno	10/15/1986	10/14/2006
Los Angeles-Central City	10/15/1986	10/14/2006
Los Angeles-Alameda Corridor	10/15/1986	10/14/2006
Los Angeles-Northeast Valley	10/15/1986	10/14/2006
Merced/Atwater	12/17/1991	12/16/2006
Oroville	11/06/1991	11/05/2006
Porterville	10/15/1986	10/14/2006
Redding/Anderson	11/06/1991	11/05/2006
Sacramento-Northgate	10/15/1986	10/14/2006
San Bernardino County/Riverside County	10/15/1986	10/14/2006
San Diego-Barrio Logan	10/15/1986	10/14/2006
San Jose	10/15/1986	10/14/2006
Yuba County/Sutter County	10/15/1986	10/14/2006

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Workforce Investment Act

Similarly, the CBP study claims that eligibility for the hiring credits can be obtained by any adult who participates in Workforce Investment Act (WIA) core services or intensive services if WIA funds are not limited. We know that statewide WIA funds are severely limited, and that the statewide evaluation underway in Davis (I am a co-principle investigator on this evaluation) documents how most local WIA boards are severely restricted in providing services to the most needy because they lack funds. Virtually no higher income people are served by the local agencies I interviewed. Again, the issue is not that some affluent people for some reason might use WIA resources and thus qualify for a voucher in an EZ, but it is necessary for the CBP authors to provide evidence of whether this is a problem or not. If the vast majority of WIA trained persons can move from unemployment to employment in a zone by qualifying for a tax credit, then this is an example of hitting the mark, but it is up to the CBP to provide concrete evidence that this is a real rather than imaginary problem.

New Jobs Confusion


The issue of limiting benefits to firms that can demonstrate the creation of new jobs is confusing in the CBP paper (p. 12). While it is broadly agreed that creating new jobs is the ultimate goal of the EZ program, it is not clear that only new jobs should qualify. For example, isn't it better in a depressed neighborhood to retain a struggling firm and keep all its workers employed rather than sacrifice a firm with the hope of attracting a new firm with new jobs? Economic developers know that it is much easier to retain a business than to attract one. The case studies we conducted illustrated many cases of firms in EZs using the program to survive rather than go out of business, retaining many jobs. The CBP study similarly does not estimate how many firms use the job credits for new jobs or for other types of employees.

The CBP paper clearly has no data to support a statement such as "the hiring credit rewards companies that create no new jobs, but have high turnover rates, more than it rewards companies that create steady employment" (p. 12). This is an inflammatory statement that could be true in some cases, but from my interviews with firms it is clear that a reliable and experienced workforce is much more important to all firms than "churning" the workforce to qualify for a slight advantage of tax credits. I think that a statement such as this must be backed up by a survey that shows a significant number of firms behaving in a way that values tax credits over a stable workforce. The point is that the CBP does not show how many hires achieve steady employment (because these data are not available), but the CBP makes a policy recommendation anyway to limit hiring credits to only new jobs.

The new jobs criteria will prove very hard to define. What is a new job? Outside of replacement hires which are not "new," most firms redefine tasks, move people internally when a vacancy occurs, lay off in one part of a firm while hiring in another. Are these redefined jobs new or not? Or does the CBP mean that new jobs occur only if a firm actually increases its gross employment numbers? Is it a new job when after a two year recession a firm hires staff to return to pre-recession production levels? To make a policy recommendation such as limiting credits to new jobs, the CBP must show that the public good is increased by some specific definition of new jobs.

Zone Boundary Issues

Another area of uncertain evidence in the CBP report concerns zone boundaries and how appropriate they are. The CBP gives some examples of affluent areas that are, by their assessment, inappropriate to be included in a zone. Again, the challenge is that the CBP must distinguish those zone boundaries that were an original mistake because of a flawed process or corruption, in contrast to the part of the zone that hits the mark. We have no clear sense of what areas were successful because of the zone designation, and what areas were not. It is also clear that some criteria for zone designation such as gang activity may make little sense at this point in time, but it remains necessary for the CBP



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to document that issues such as gang activity actually have led to inappropriate zone designations. From what I understand, at least initial zone boundaries were very carefully assessed through very complex competitive evaluations. Fortunately, this can be evaluated and future zone designation criteria can be set with the benefit of insights from what worked and what did not work in the past.

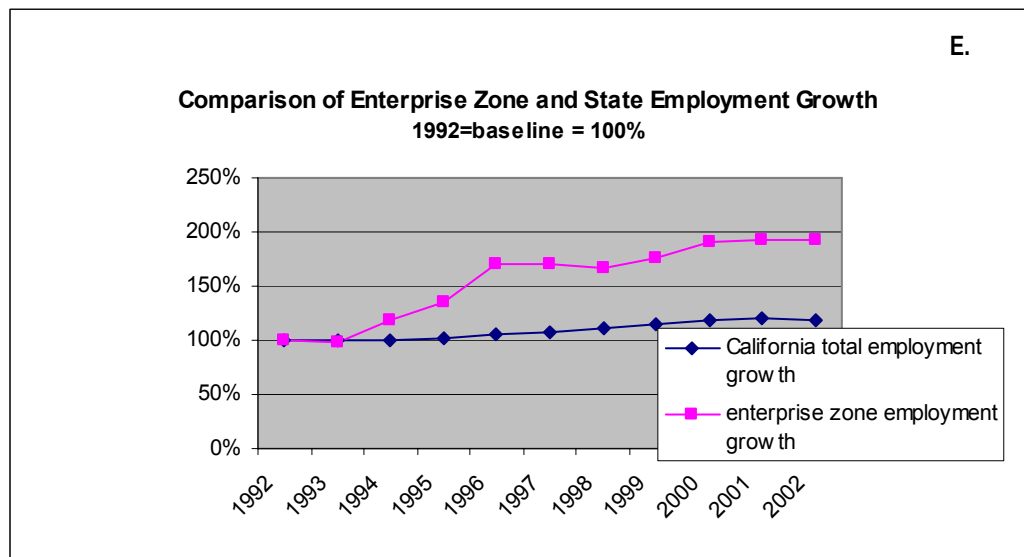
When should an improving area be taken out of a zone? This is a related question. One of the attractive features of a zone is that firms moving in, staying, or expanding can look forward to benefits for some length of time. If zones can arbitrarily, under state orders, be reduced in size when a part of the zone becomes successful, this will severely limit participation in zone success. The CBP report needs to document that early redrawing of zone boundaries would not severely reduce program effectiveness in those areas where it is now most successful. There is strong evidence that careful designation of areas that will receive benefits for more than five years is essential to program success.

There is agreement that some zones deliver benefits to areas which are not in need of assistance. The example of Downtown San Francisco is frequently cited—and it is probably the case that some businesses in San Francisco might have done very well without zone benefits. A careful look at San Francisco EZ boundaries reveals that neither the Union Square nor the downtown Financial District are in the zone. However, the nearby Tenderloin and much of the South of Market area in the San Francisco Zone have experienced a huge revitalization for which the EZ probably deserves to take substantial credit. We need to better understand both the benefits and costs of zones that border affluent areas.

Large vs. Small Firms

Simply claiming tax credits is not a sign that the program is failing. If large corporations claim most tax credits, is it because they are milking the system, or is it because in fact the vast majority of employees work for large corporations? Since the benefits of the California EZ program offset corporate taxes, it makes sense that the largest taxpaying firms would be most interested in claiming benefits. Thus, it might be that the claims are reasonably distributed in the state. Moreover, it also may be the case that claims require legal and clerical overhead so that only large companies can afford to (and are informed enough to want to) go through the processes of making claims. These issues were not considered by the CBP, and as a consequence they suggest that the program is not hitting the mark—but again there is no evidence provided.

The size of the firm matters less than the fact that it assists in the revitalization of an area. Most economic developers believe that a large firm in an area helps stimulate smaller ones nearby that support it, creating even more jobs. The multiplier of a local firm is essential. This relationship is not explored by the CBP.



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Retroactive Vouchering

Considerable controversy involves retroactive vouchers. Many argue that the purpose of the zone is to stimulate hiring disadvantaged workers and that it does not make sense to retroactively reward firms with an incentive for something they have already done. In contrast, the CBP report does not talk about the way the program works right in actually stimulating growth in businesses where claims are made retroactively for legitimate reasons. The need for understanding how retroactive vouchers work to assist firms in the zone meet their mission is essential.

An Out of Date Report When It Was Published

Interestingly, the CBP report is dated April 2006 and it is already out of date. For example, it does not include many positive current developments such as the fact that the Oakland Enterprise Zone has responded to the audit which claimed it approved questionable out-of-area voucher applications (p. 12) by immediately stopping that practice, and it implemented some of the most stringent vouchering standards in the state. There is another way to interpret this example besides the fact that Oakland compromised the intent of the EZs. Since the practice of out-of-area vouchering had been ongoing for some years and it was just determined in March 2006 that only the local government that administers the Enterprise Zone may issue a voucher for an employee in that zone, why did it take so long for the state to identify this as a problem and to seek more control over the procedures used to issue vouchers?


Most importantly, the Oakland example is history now and the response to this problem should have been included by the CBP to demonstrate how effective management can help the zones address problems so as to not miss the mark. Moreover, the process by which the Oakland issues were resolved should have been used as an illustration of how zones are responsive to effective state management. The CBP also fails to note that out-of-area vouchering has been legally defined as wrong and all agencies have been ordered by the Department of Housing and Community Development to end the practice. Thus, the administrative system for zones works, though in this case slowly.

Correcting A Misguided Premise

The CBP paper uses a misguided theory of why zones work. They believe that the zone benefits come from individual firms getting a single benefit and increasing their employment, thus adding that little bit to the zone economy. This is a trivial part of what really happens in zones, and the value of the zone derives from a much more sophisticated theory.

The theory for why the EZ program works in depressed areas is built on the notion of reversing the spiral of decline. When areas are depressed and suffering from declining employment and business viability, they get into a self-reinforcing spiral of deterioration. The closure of a factory means people lose income, which means they spend less money in retail stores. Many vacant retail stores makes it impossible to recruit new firms, and the city collects fewer taxes to invest in maintenance and services which will attract business. The most affluent people move out, further depleting local capacity. Most of the zones I have studied have had some version of this going on.

The response to this spiral of decline has recently been termed "spiraling up" (F) where multiple programs in concert reverse the many forces of decline and turn them into growth. A few strategically located businesses and projects create a sense of opportunity and optimism, which encourages other firms to remain in the area or to expand. Some new opportunities emerge. Economic development programs and non-profit agencies then see some hope and they step forward to invest in the area. Redevelopment projects become viable and get funded. WIA program offices start serving the area with new vigor. Once public investments are made, private investment follows and public funds can be allocated to areas not yet experiencing the boom.



It is in the economic interest of the state to have one strong, combined, and business-friendly incentive program to help attract business and industry to the state, to help retain and expand existing state business and industry, and to create increased job opportunities for all Californians.

The Enterprise Zone Act, California Government Code, 7071 (b).

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Conclusion

A key point is that California's EZs are probably the most successful in the nation—in most states there is no evidence that zones work at all or that they get much attention. The core of the California program remains highly effective, though we need to know which areas are experiencing problems, a case which is not made in the CBP report.

Furthermore, problems in the program such as outdated or ineffective regulations and inadequate oversight are issues that currently are being addressed through the regulations being developed by the Department of Housing and Community Development. Massive downsizing of the program or draconian new restrictions on its operation are misguided and premature before the Department of Housing and Community Development completes its current updating of the regulations.

The California EZ program does not cost the state a lot of money. Keep in mind that Alabama offered Mercedes \$253 million in incentives to locate one plant in their community and create 1,500 jobs at an average cost of \$168,000 each—an amount the state will probably never recover through expanded tax receipts related to that factory. Each year the state Enterprise Zone program costs only slightly more than this one recruitment effort, and yet it is a key part in a massive statewide job expansion involving tens of thousands of jobs per year.

The California EZ program stands out as an example nationwide because it targets disadvantaged areas and it promotes the hiring of disadvantaged workers. This is the right way to run Enterprise Zones, and overall the California program has been successful in transforming many distressed areas that otherwise would remain in the spiral of decline.

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