

# Fiscal Policy

## Enterprise zones in Colorado

A survey of research



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# Enterprise zones in Colorado

## Introduction

Enterprise zones (EZ) are economically distressed areas where tax credits and other financial incentives are offered to businesses to encourage investment and job creation.<sup>1</sup> Typically, urban or rural areas with high unemployment rates, poor infrastructure and inadequate social services are designated as EZs.<sup>2</sup> These low-income areas often have inadequate access to transportation, investment capital and skilled labor. The zones also tend to have poor environmental conditions and are prone to social problems such as crime.

State and economic-development officials say that EZs are a necessary and useful tool to promote economic development. Proponents claim that incentives lead to business investment and job creation in the neglected areas. They further say that creating new jobs will increase incomes and demand for goods and services, thereby increasing revenues and allowing for improved public services such as transportation.

This paper reviews some of the studies that have evaluated the impacts and effectiveness of EZs in creating local economic growth, with particular focus on Colorado.

Taken together, studies suggest that EZ incentives result in minimal investment and job creation and produce few significant economic benefits.<sup>3</sup> In fact, research indicates that incentives are neither a cost-effective strategy for achieving economic growth nor a major consideration when firms make decisions to relocate or invest in an area. The most important

factors for businesses include availability of high-skilled labor, good infrastructure and access to research institutions.<sup>4</sup>

## History of enterprise zones in the United States

Enterprise zones were introduced in the United States in 1980, and the stated goal was to alleviate poverty in decaying inner cities. Initially started in the United Kingdom, the EZ concept was based on the premise that market-oriented incentives could be used to lure businesses and in turn overcome economic barriers, create jobs and increase incomes in targeted economically deprived areas.<sup>5</sup>

The Reagan administration embraced EZs but could not get the congressional support necessary to pass relevant legislation. The initial resistance in Congress encouraged states to take the initiative and begin experimenting with EZs as a tool for economic development. Connecticut became the first state to enact laws to support EZ programs in 1981. In 1993, Congress approved the creation of nine federal empowerment zones.

EZs have been touted as one of most important economic-development policy innovations at the state level. Some states rely on EZs as part of an industrial-development strategy, while others use them for commercial development. The overall focus for most is job creation and job retention.<sup>6</sup>

In 1995, there were approximately 2,840 zones in 40 states; today there are about 3,000 zones with varying names and incentives in 43 states.<sup>7</sup> The prevalence of the zones varies among the states, with New Mexico having one zone and Louisiana designating 1,700. Some states, including Arkansas, Kansas and South Carolina, have designated their entire states as enterprise zones.<sup>8</sup>

## History of enterprise zones in Colorado

The Colorado Urban and Rural Enterprise Zone Act of 1986 established a program to provide incentives and tax credits for private enterprises to expand and for new businesses to locate in economically distressed areas. Statutes currently limit the number of zones to 16 areas that vary in size (see map, page 4). EZ designation

### At a glance: Enterprise zone tax credits in Colorado

- 3%** for investment on equipment
- 10%** for job-training programs
- 3%** for research and development
- 25%** for rehabilitation expenses
- 25%** for in-kind donations
- \$500** for each new employee added



# Enterprise zones in Colorado

requirements specify that areas must have:

- Unemployment rates at least 25 percent above the state average
- Population growth rates at least 25 percent below the state average
- Per capita income less than 75 percent of the state average<sup>9</sup>

In addition, the total population within any enterprise zone cannot exceed 80,000 in urban areas or 100,000 in rural areas. EZs account for approximately 70 percent of the state's land area and award millions of dollars in tax credits, making the program Colorado's largest single economic-development program.<sup>10</sup>

## Overview of Colorado enterprise zones

### Types of incentives

Colorado offers six different income tax credits and one sales-and-use tax exemption to corporations, business partnerships and individuals to encourage them to move to or expand operations in designated zones. They include:

- 3 percent for investment in equipment used exclusively in enterprise zones
- 10 percent of the total investment and expenses for job-training programs
- 3 percent for research and development funds spent by firms in enterprise zones
- 25 percent of rehabilitation expenses for firms that rehabilitate older, unoccupied buildings
- 25 percent for monetary or in-kind contributions to approved nonprofit or local economic and government projects located in enterprise zones

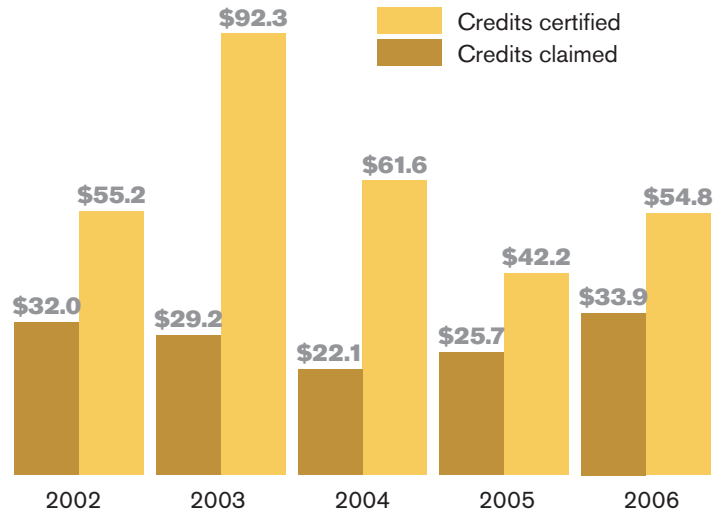
For new businesses, there are three potential credits: \$500 for each new employee added; an additional \$200 health insurance credit for each new employee for the first two years of operation; and an additional \$500 per employee for jobs in agricultural processing.

Finally, the sales-and-use tax exemption helps firms to purchase machinery and machine tools, particularly for mining or oil and gas operations in enterprise zones.<sup>11</sup>

### Amounts of credits awarded

Enterprise zone tax credits peaked in 2001 at more

**Chart 1: Enterprise zone credits claimed and certified, 2002-06 (in millions)**



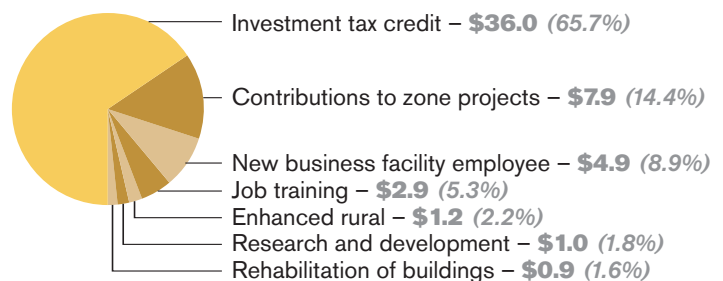
Source: Department of Local Affairs, "Summary of economic indicators and tax credits certified by fiscal year"

**Note on chart:** The total amount of tax credits **certified** by zone administrators is typically higher than the amount actually **claimed** and reported by the Department of Revenue. The certified amount represents potential credits that firms qualified for, while total credits claimed with the Department of Revenue are limited by a taxpayer's income tax liability each year. If a certified credit exceeds the income tax liability of a taxpayer, it can be carried forward for a certain number of tax years. (*Colorado EZ Annual Report, 2006*)

than \$60 million, according to a 2002 auditor's report.<sup>12</sup> Since then, they have ranged from \$22.1 million to \$33.9 million, according to a report by the Colorado Economic Development Commission<sup>13</sup> (chart 1).

Even though the tax credits are designed to attract a variety of investments, ranging from equipment to job training to rehabilitating old buildings, an analysis of

**Chart 2: Enterprise zone tax credits, 2006 (in millions)**



Note: The New business facility employee credit total includes agricultural processing and health insurance credits.

Source: Colorado Department of Local Affairs, Annual Enterprise Zone Report, 2006



## Enterprise zones in Colorado

credits in 2006 shows that firms claimed significant credits on investments in equipment (66 percent) and relatively little in areas that increased job creation<sup>14</sup> – job training (5.3%) or adding employees (8.9%) (chart 2).

### Effectiveness of EZ incentives

#### National studies

A review of EZ studies in several other states indicate that zones vary widely in terms of zoning laws, land-use patterns, incentives and administrative styles. These differences can be found even among zones in the same state.<sup>15</sup> Because of these variations and lack of access to certain data, research methodologies have been unable to draw conclusive results regarding the achievements of zones. In addition, studies of EZs vary in scope, which means results are not directly comparable.

Most of the studies state that there is some evidence of positive impact on economic growth, but those that go into greater detail suggest there is little benefit in terms of job creation. Some studies indicate that the amount spent to create each job is very high, and other studies found that zones do very little to expand employment and reduce unemployment in designated areas.<sup>16</sup> Among the findings:

- Even though a typical incentive package represented a cut in state and local taxes of about 30 percent, only about one in 10 new jobs in the average community can actually be attributed to the incentives.<sup>17</sup>
- Jobs created in zones turn out to be expensive to produce – for example, an analysis of tax information from 75 cities found that incentives averaged \$7,793 per job, and the estimated revenue loss was as high as \$70,423 for each job.<sup>18</sup>
- Jobs typically are not of high quality and typically pay low wages. Studies show that zones mostly attracted branch plants rather than smaller or locally based enterprises that were more likely to create employment.<sup>19</sup>
- Most workers did not live in the zones where they worked, even though the tax credits are aimed at increasing employment within zones, according to a study of commuting patterns in a number of states.<sup>20</sup>

Other studies had broader findings:

- Plant-level data from 11 states found that EZs do not have a positive mean impact on the growth rates of

employment, per capita expenditures, sales or payroll per employee.<sup>21</sup>

- Even though the existence of zones reduced overall unemployment claims, unemployment rates of zone residents fell only slightly more than those of non-zone residents, according to studies of Indiana EZs in 1993 and 1994.<sup>22</sup>

Combined, these studies affirm findings by studies in California<sup>23</sup> and New Jersey that found that zones have minimal impact on local employment.<sup>24</sup>

Even so, many states perceive EZ incentives as a necessary cost to attract business.<sup>25</sup> The primary reason is the competitive environment that has emerged between states in a quest to promote economic growth.

#### Colorado-specific studies

Colorado's law requires each enterprise zone to adopt specific objectives with measurable outcomes. Zone administrators are required to compile annual reports that measure whether zones meet economic-development objectives. Those laws and rules are not always followed.

In 2002, performance auditors from the State Auditor's Office carried out interviews, analyzed data from the departments of Labor and Employment, Local Affairs and Revenue and made visits to EZ sites.<sup>26</sup> The auditors found that economic-development objectives were not measurable for many zones because they lacked sufficient data to determine their achievement. In some cases, in fact, zone administrators did not even maintain lists of businesses located within their zones.<sup>27</sup>

Various research methods, including surveys and regression analyses, have been used to evaluate the impacts of EZs in Colorado. A complex, contradictory picture emerges because the documentation indicates that within the EZ program, some specific industries in certain locations find success while others fail. The complexities are highlighted by Alm and Hart's 1998 econometric analysis of Colorado's EZs, which acknowledges the controversies resulting from these policies.

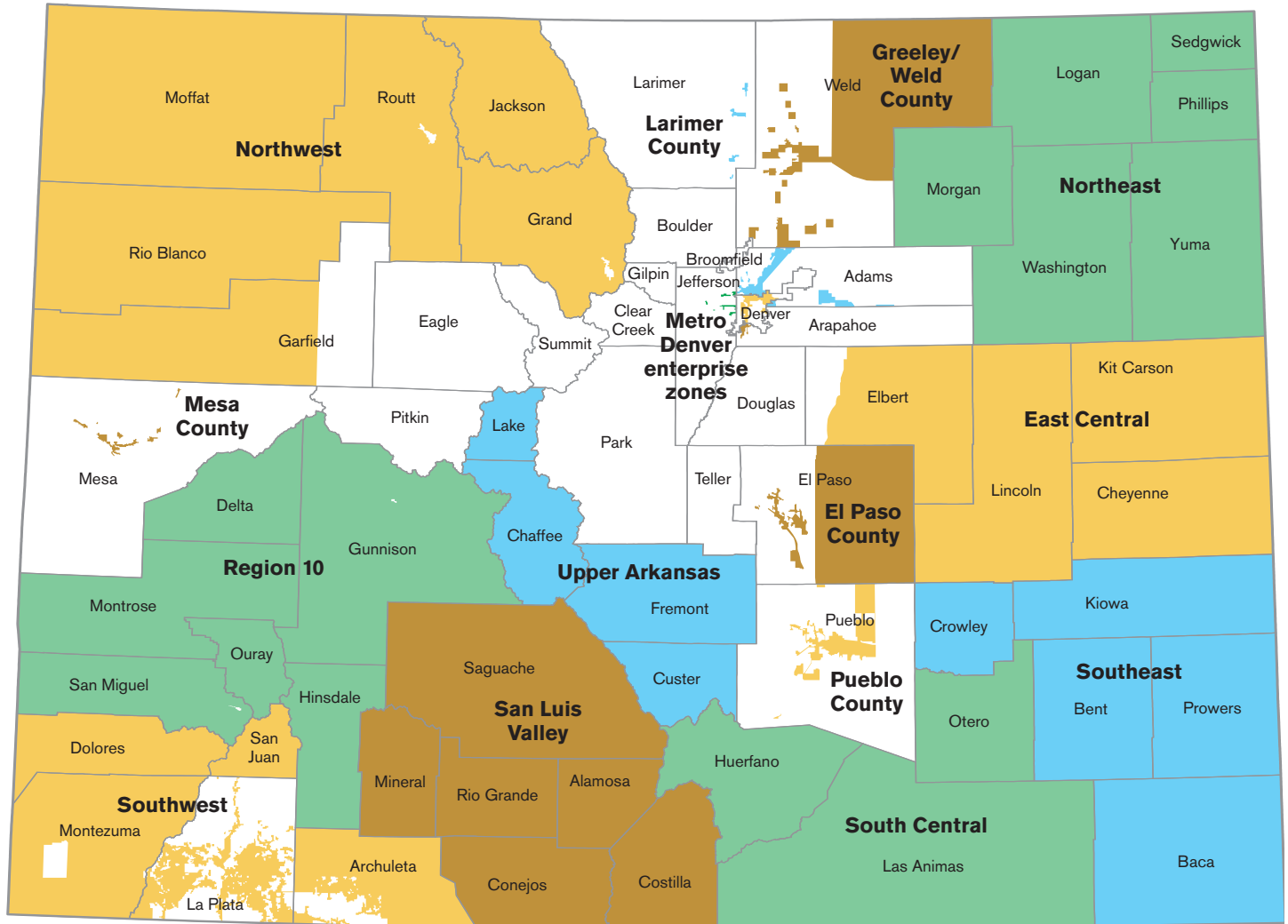
While Alm and Hart identified significant increases in per capita incomes and improvements in employment conditions in zones,<sup>28</sup> a subsequent 2004 study by Lynch and Zax shows the difficulties in isolating effectiveness without controlling for location and specific industry.

Using establishment-level data that included employment size and type of industry, Lynch and Zax measured the impact of zones on employment and



# Enterprise zones in Colorado

Map 1: Colorado's enterprise zones



Sources: Economic Development and International Trade Annual Report, 2006; [www.advancecolorado.com/ezmap](http://www.advancecolorado.com/ezmap)

incomes. Using Social Security taxation data, they were able to focus on specific industries, locations, quarterly employment and payroll for all establishments within the zones.

The comprehensive coverage allowed Lynch and Zax to identify the risk of ignoring important variables often missed in EZ analyses at aggregate levels; the data enabled them to focus on the micro level rather than the macro level. By controlling for industries, they were able to determine which sectors were impacted by the presence of EZs.<sup>29</sup>

In reviewing other methodologies, Lynch and Zax argued that the use of surveys was unreliable because, in most cases, the businesses and zone administrators sampled were not objective in their responses because

they had a stake in the outcomes of the studies. Their study acknowledged Alm and Hart's 1998 study findings but pointed out that employment and per capita income growth could not conclusively be attributed only to the EZ programs.

In order to avoid biases and exclusion of important considerations, Lynch and Zax recognized that EZs were not similar across industries and locations. Their study showed that the level of potential employment was higher in firms with not more than ten employees.<sup>30</sup>

Using employment figures for 2000, they compared similar establishments located in both zone and non-zone areas; they found that establishments with ten or fewer employees located in an EZ had a greater level of potential employment. However, for establishments

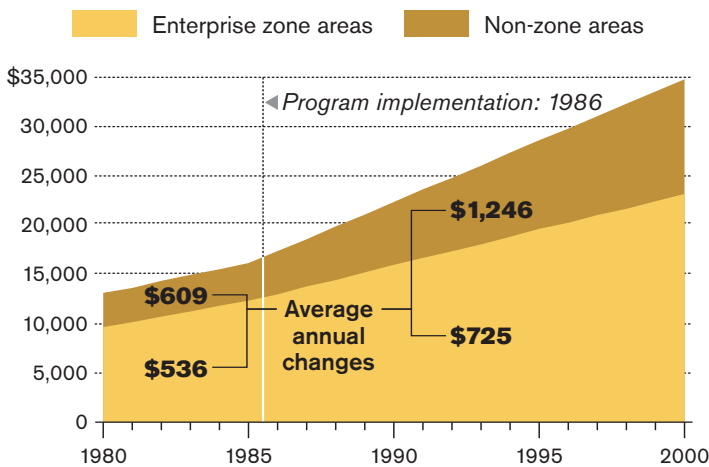


## Enterprise zones in Colorado

with more than fifty employees located in EZs, lower employment was recorded than similar establishments not located in an EZ.<sup>31</sup>

Furthermore, when Lynch and Zax looked at blighted areas that qualified to be EZs but were not recognized as such, they found that there were hardly any economic differences between them and EZs. Their findings suggest that the incentives do not make a significant difference in terms of expanding economic growth.

**Chart 3: Changes in per-capita income, 1980-2000**



Source: Office of the State Auditor's analysis of per capita income data from the Colorado Office of Economic Development & International Trade

An analysis of per capita incomes in zone and non-zone areas between 1980 and 2000 in Colorado found that non-zone areas had greater annual gains in per capita income.

The 2002 analysis by the state auditor found that the gap in per capita income grew wider after implementation of the enterprise zone program (chart 3). The report found that the average annual increase in per capita income before EZs was \$539. After EZ designation, per capita income grew by \$725 annually. In non-zone areas, per capita income increased from \$609 to \$1,246 annually in the same period. The report concludes that the gap between zone and non-zone areas increased by a ratio of almost 2:1.<sup>32</sup>

This means that per capita income in non-zone areas has been increasing at a faster rate than in zone areas, and it has done so for the 20 years that enterprise zones have been in existence.

## Enterprise zones have not kept pace in job-creation

For all the investment in enterprise zones, more jobs were created in non-zone areas than in zone areas, according to a comparison of employment and personal income numbers. In fact, in the area of job creation, there is hardly any justification for EZ credit allocations. Investment returns, measured by growth in employment and income, do not match or support the claims.

Because the tax credits are not targeted and are available to all qualifying firms located in EZs, incentives could go to large firms and multi-national corporations, resulting in potentially unfair competition for small businesses.

## Conclusion and recommendations

Enterprise zones have been praised and embraced as an important policy innovation that is necessary and useful for economic development, and there is always a temptation to dismiss any criticism of waste and excess as anti-business bias. Proponents argue that EZ credits lead to business investments, particularly in neglected areas, resulting in overall growth of the state economy.

However, a majority of studies shows that EZ incentives result in minimal long-term investment and job creation. National and local studies both suggest that incentives are not a cost-effective strategy for achieving economic growth.

The job-creation goals of EZ programs are rarely met because, as stated, more credits are granted for capital investment than labor investment. The result is that firms are more likely to mechanize operations than invest in creation of new jobs.

Even though many states perceive incentives as a necessary cost, research suggests that states should continuously re-examine the need for incentives, because they focus on attracting new business and less on retaining existing ones. In addition, the academic literature reveals that tax incentives are not a major priority when firms make decisions to relocate. High quality services, availability of a well-trained workforce and quality of life are far more important to firms when they are making location decisions.

Colorado has spent millions of dollars on the EZ



# Enterprise zones in Colorado

program in the past 20 years. The returns in terms of employment and income levels have not met the desired investment goals, and designation of EZs has done very little to increase incomes and reduce unemployment within zones. Therefore, EZ incentives are not a cost-effective strategy for achieving economic growth.

Especially in light of the recent economic downturn and pressure on the state budget, the renewed push for the expansion of enterprise zones in Colorado should be approached with caution. With 70 percent of the state already designated as an enterprise zone, it seems certain that further expansion will deny the state much

needed tax revenue as corporations take tax credits against millions of dollars in profits. Shortages in revenue inhibit state and local governments' ability to finance critical services.

With a projected \$800 million shortfall in the state budget this fiscal year, and given what we know about EZ programs, the state's commitment to economic growth and support of businesses should be open to entirely different approaches, including devoting resources to alternatives such as statewide investment in infrastructure and education.

## End notes

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