In the Enterprise Zone

"An Evaluation of California's Enterprise Zone Programs" by David E. Dowall, in *Economic Development Quarterly* (Nov. 1996), Sage Publications, 2455 Teller Rd., Thousand Oaks, Calif. 91320.

Nearly 40 states now have enterprise zone programs that give tax breaks to businesses in blighted inner-city areas. The aim is to stimulate economic development. In California, the results have been underwhelming, says Dowall, a professor of city and regional planning at the University of California, Berkeley.

He looked at 13 of his state's 34 enterprise zones, ranging from the Barrio Logan area of San Diego in the south to Eureka in the north, and including the Watts, Central City, and Pacoima areas of Los Angeles. All were launched in 1986. Over the next four years, Dowall found, the number of firms operating in the zones increased by only 287 (to 8,018), or less than four percent. There was evidence of unusual job growth (relative to the particular county and industry) in only two zones (Pacoima and San Jose), and even in those, the programs may not have been responsible. Of 159 businesses that Dowall surveyed, only 36 said their decisions about location or expansion had been influenced by the incentives.

Tax records indicate that businesses in the 13 zones claimed some $10.6 million in state income tax credits between 1986 and 1990. Fewer than 1,000 jobs—only about six percent of the total net increase—were ostensibly "created" as a result. The credits, representing less than one-half of one percent of the total net taxable income ($2.7 billion) earned by zone businesses, were too small, Dowall notes, to have much impact. He favors throwing more money at the problem, including regulatory relief and financial and technical aid for zone businesses, investments in infrastructure, and job training.

Diminished to Death

"Increasing Returns and the New World of Business" by W. Brian Arthur, in *Harvard Business Review* (July–Aug. 1996), Boston, Mass. 02163.

The law of diminishing returns is one of the most useful contributions economics has made to humanity's tiny stock of comfortable truisms. Now, however, economists may have to take their gift back.

The law holds that a producer who continually increases output will eventually encounter limits: pouring more resources into production will yield diminishing returns. A farmer, for example, will eventually be forced to put lower-quality land into production, cutting profits. Diminishing returns, in the writing of the great 19th-century economist Alfred Marshall, were a crucial force in bringing prices and market shares into equilibrium in a market economy.

The principle still largely fits the "bulk-processing, smokestack economy," argues Arthur, an economist at Stanford University, but in today's high-tech economy, a new "law" is in effect: the law of *increasing* returns.

High-tech goods are different in large part because their production costs do not rise. High-tech producers put most of their money into research, not production. The first copy of Windows cost Microsoft $50 million; subsequent ones cost $3 apiece. The law of diminishing returns does not operate through costs alone. An automaker, for example, suffers diminishing returns when it exhausts the customer base for its brand. Beyond a certain point, Ford must cut prices to sell more Tauruses.

But such limits do not always completely apply to high-tech products, Arthur contends. "If a product or a company or a technology—one of many competing in a market—gets ahead by chance or clever strategy," he maintains, "increasing returns can magnify this advantage, and the product or company or technology can go on to lock in the market." That is what happened in the early 1980s, for example, in the market for operating systems for personal computers. Even though computer programmers regarded it as an inferior system, DOS eventually prevailed over its competitors. Users had too much invested in learning the ways of DOS to switch. Software developers put more of their efforts into writing programs for DOS. Microsoft got a lock on the market.

The law of diminishing returns still applies in the traditional, bulk-production part of the