How to Design Effective Enterprise Zone Legislation

by Stuart M. Butler, Ph.D.

It is heartening to see Congress apparently moving to take action to establish federal tax incentives envisioned in the enterprise zone idea, some ten years after the concept was introduced from Britain. While the early debate over enterprise zones did not lead to any federal legislation till 1987, when Congress enacted a very diluted form of the idea without the needed tax incentives, that debate did have two very important results that will help Congress now to craft effective legislation. First, it sparked an intense discussion over the nature of economic development in depressed neighborhoods. This discussion led to a much better understanding of the importance of small firms in job creation, and of the vital importance of community-based organizations in mobilizing local resources and talent. We now understand that if there is to be strong economic development in the inner cities, the core of business activity must come from small enterprises.

The second result of the debate in the early 1980s has been the passage in over 30 states of state-based enterprise zones. These state zones, beginning with Connecticut in 1982, have brought solid results despite the weak tax incentives usually available at the state level. The study of the New Jersey Enterprise Zone Program, the most recent analysis of a state, corroborates the general finding that well-designed state enterprise zones can have a significant impact on economic conditions in depressed areas. This body of experience at the state level bolsters the contention that a federal enterprise zone program, with its more powerful tax incentives, could have a decisive effect on the economy of America's inner cities.

With the bipartisan enterprise zone legislation introduced in the House earlier this year (H.R. 6) by New York Congressman Charles Rangel, and the similar legislation introduced in the Senate by Minnesota Senator Rudy Boschwitz, we have at last an opportunity to enact strong and effective enterprise zone legislation to help revive the inner cities. But if the support for enterprise zones among congressional leaders and the Bush Administration is to lead to the best possible legislation, Congress must remember the debate of the 1980s and design a program founded on the fundamentals of urban development crystallized in that debate. This suggests that Congress should craft new legislation based upon four key principles.

1) Federal enterprise zones should spur local creativity, not attempt to micromanage local economic development.

The enterprise zone concept is based on the notion that even within very depressed areas there are resources – now often dormant or engaged in illegal activity – that can become the basis of legitimate new economic activity. Even in such blighted areas as the South Bronx there are underused or vacant buildings that could become the home of small firms. There are aggressive and creative community organizations that currently are able to mobilize the people to tackle the social problems that discourage enterprise. And there are

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Stuart M. Butler, Ph.D. is Director of Domestic Policy Studies at The Heritage Foundation. This is his testimony before the Senate Committee on Small Business on September 21, 1989.

ISSN 0272-1155.

in fact many small enterprises, either operating in the underground economy or engaged in illegal activity. By reducing the tax, regulatory, and other barriers to legitimate enterprise, these resources can be brought together in economic development for the benefit of the neighborhood.

Precondition, Not Panacea. In order to ignite economic activity, the enterprise zone programs should focus on establishing the best economic climate to foster entrepreneurship. This attractive climate, however, is a precondition for economic improvement and not the panacea. Other ingredients are required for economic development, many of them not strictly economic tools. Action needs to be taken, for instance, to tackle the staggering increase in drug use and crime within the inner cities: the National Drug Policy recently unveiled by the Bush Administration has a key role in tackling this deterrent to legitimate enterprise. Similarly the problems of the schools must be addressed, by introducing strong parental involvement through such devices as open enrollment and site-based management of schools. In addition, a policy for the inner cities must allow community-based organizations to take a leading role in providing services within the neighborhood, which in turn creates entrepreneurial opportunity and employment. That is one reason why HUD Secretary Jack Kemp's strong support for resident management of public housing is so important. Similarly, heavy welfare dependence in the inner cities must be reduced through innovative welfare reform initiatives, such as those spearheaded in recent years by the states and made possible through waivers from federal regulations granted by the Reagan Administration.

Thus enterprise zones should be seen not in isolation, but rather as an economic dimension to a general strategy of stimulating creativity and empowerment in the inner cities. Enterprise zones are but one vital ingredient in what should be seen as a new war on poverty, where blighted urban neighborhoods are the first battlefield.

"Urban Frontier." This emphasis on encouraging creativity by the "local troops" in the war suggests that federal policy in general, and a federal enterprise zone program in particular, should not try to micromanage initiatives in each neighborhood. Conditions are very different in different places. An approach that works well in one city may be ineffective in another. Thus we need to guarantee the highest degree of freedom for cities and their neighborhoods to experiment with new ideas to promote economic activity. Much like the frontier during the great movement west in America, where the remoteness of central government allowed creative local solutions to be applied to problems and opportunities faced by pioneers, the inner city should be seen as an "urban frontier."

This means an enterprise zone strategy should confine itself to establishing the best possible climate in incentives and barrier removal, and then allow those closest to the situation to design the details of the strategy. This means Congress should not load up an enterprise zone program with a wide range of well-meaning financial packages or finely-tuned incentives designed to promote particular kinds of ventures. Micromanaging the economy does not work in less developed countries; it does not work in America's inner cities. What government should do is establish broad, powerful stimulants to economic activity within a relatively simple framework, and allow a thousand flowers to bloom.

2) Congress should assure there is competition in the designation process.

There are some supporters of the enterprise zone idea who argue that federal enterprise zone incentives should be applied to any area that meets certain eligibility requirements. Such an "entitlement" approach would be a mistake. Enterprise zones should not be seen as federal manna from heaven, descending upon cities, but rather a federal dimension to complement a process of creative economic policy at the state and local levels. When it seemed probable in the early 1980s that Congress would pass legislation to establish a limited number of zones, states and cities began devising very innovative strategies for encouraging economic development in the inner cities. Their aim was to have an "inside track" in the selection process for designation, should a federal program be enacted. Had Congress been considering an entitlement program for enterprise zones, there would have been much less of a stimulus for this creativity.

Thus I would urge Congress to stay with the principle that enterprise zone legislation should be seen as limited in its extent and in the number of designations, in order to encourage new approaches at the state and local level.

3) The zones must focus on small business.

Many state and local development officials continue to believe that the best way to assure economic growth in a poor neighborhood is to encourage large companies to locate there. They take it as self-evident that a firm employing 100 people must be better than one employing three. They also assume that progress is impossible unless a large firm is persuaded to become the nucleus or anchor for economic expansion.

In almost every instance this is an unwise strategy. The fact is that large firms are poor generators of new jobs. Research by David Birch at MIT and others indicates strongly that it is small firms that are the primary generators of jobs in the U.S. – in fact the large firms in recent years have shown a loss of net new jobs. But large companies are not appropriate targets for another reason. Studies of location decisions of large firms indicate that chief among the factors influencing the decision are the availability of properly trained employees and an environment conducive to attracting and keeping skilled workers and managers. Tax incentives are well down the list of factors. Thus when a city attempts to retain a large company, or attract a new venture to a blighted neighborhood, through a package of tax and other financial incentives, the price to the city is extremely high. This price is increased by the understandable reluctance of other cities to accept the relocation of one of their large firms. Thus we see a "war of incentives" between competing cities with a very high cost for the taxpayer and yet very little real economic stimulus to the city that "wins" the location war.

Drawing from Underused Resources. Thus a federal enterprise zone program will be both expensive and largely ineffective if it seeks to recruit large companies to depressed urban neighborhoods. Instead the focus should be on creating the conditions necessary to generate new small enterprises, preferably drawn from the underused resources within the neighborhood itself.

Other than the practical reasons of job generation and location decisions, there are many other reasons for focusing on small enterprises as the foundation for economic recovery in depressed areas. For one thing, small firms tend to be more innovative and better able to adapt to unusual economic and social conditions. The urban analyst, Jane Jacobs, in her book, *The Death and Life of Great American Cities*, also points out that risk-taking, innovative firms need to keep overhead costs as low as possible, so older buildings and low-cost neighborhoods are their natural habitat. Firms based on tried and trusted ideas locate in new buildings and neighborhoods. In addition, small firms require modest capital and usually less sophisticated technology and worker skills. They recruit workers locally –

more often than not from people who walk in off the street. Clearly these firms are more appropriate for areas where capital and skills are in short supply.

Small firms, moreover, can be established by city-based organizations as part of their general program of reviving a neighborhood. One of the interesting features of the growth of tenant management in public housing, for instance, is that these management associations very quickly diversify and create businesses both to employ local residents and to improve the availability of goods and services to the neighborhood. By removing the red tape so often in the way of such ventures, the economic objectives of the enterprise zone strategy can be combined with a more general approach to addressing the conditions of an inner city.

4) Tax incentives should stimulate small, start-up businesses.

This focus on new, small business creation as the foundation of an enterprise zone strategy suggests different tax incentives than we would use in a program aimed at larger firms. It also means that any enterprise zone program should reduce the costly burden associated with local regulation. If we are to foster the growth of small enterprises within large dilapidated resident neighborhoods, the program should encourage local authorities to streamline zoning, building codes, and other regulations and permits that can be an enormous obstacle to a small firm. Even simplifying the regulation process in the form of "one-stop shopping" procedures can be enormously beneficial by reducing the crippling cost of delays in obtaining appropriate permission.

In the case of tax incentives, the proprietors of small firms correctly point out that they lack the sophistication to use complex tax incentives. Thus, simple tax incentives are required. Owners also emphasize that their primary need is not reduction of taxes on profits – most make little or no profit in their early years on which to pay taxes. What they need are tax measures that will encourage investors and lenders to provide them with the long-term capital and working capital they need to start and develop their businesses. In addition, small firms, particularly those in high-risk depressed areas, tend to be chronically short of cash. Thus tax incentives to improve their cash flow, enabling them to take on labor and meet the other routine requirements of running a business, are crucial to success.

This suggests that Congress should focus on two broad forms of tax incentive in a federal enterprise program:

A) Taxes on Debt and Equity Capital. In order to provide an incentive for lenders and investors, Congress should consider the elimination of capital gains taxes for investments in enterprise zones. This would encourage investors to take the higher risk of putting their money in a depressed neighborhood, and it would encourage the proprietors of enterprise zone businesses to build them up over the long haul.

Such relief from capital gains taxes should not be restricted to certain types of investment. Restricting the relief, say, to investments in real estate development would shift economic activity away from less capital-intensive ventures that may in fact be more appropriate to the neighborhood. Trying to steer investment and loans to particular types of activity is just the kind of micromanagement that the enterprise zone program should avoid.

There are ways to limit the total revenue loss to the Treasury (assuming for the sake of argument that new activity does not generate net new revenue). To encourage investors to keep their money in the zones as long as possible, rather than taking out the cash once a reasonable capital gain is achieved, the capital gains tax incentives should be structured much like the capital gains tax relief on the purchase of a home. In the case of housing, the gain is not taxed until it is eventually taken out of housing rather than simply being rolled over into another home. In addition, there is a one-time capital gains exclusion for those over the age of 55 who sell their homes. A similar approach could be used in an enterprise zone. Thus rather than make all gain tax free, Congress could require an individual to roll over a capital gain from an enterprise zone business into another enterprise zone venture for the gain to remain free of tax. Only when the net gain was taken out of the zone would tax apply. In addition, like the one-time exclusion for housing, an additional benefit to encourage small business owners would be a one-time capital gain exclusion of, say, $100,000 for an owner-operator of a business.

This limit on the total exclusion of a capital gain also would discourage investors and businesses from using enterprise zones merely as tax havens, while providing little economic stimulus to the neighborhood. Yet the limit would not inhibit small business. Another way of limiting the cost of the total package – while retaining the powerful stimulus to small enterprise – would be to place annual limits on the amount of an investment by an individual taxpayer that would be subject to any tax benefit. The amount of investment funds received or money borrowed by a firm that provided tax relief to the investor/lender also could be subject to an annual limit. In this way, the full tax relief would apply to small-scale firms, but a large firm would find the available tax benefits to be small in comparison with its scale of operations. As mentioned earlier, tax relief is in any case a marginal consideration in location decisions by large firms, and so these limits would be an effective safeguard against relocation and to major firms using zones as a tax loophole without having much local economic impact.

B) Payroll Taxes. Payroll costs are the other major obstacle for small firms in depressed neighborhoods. The Rangel-Boschwitz legislation now before Congress addresses this by applying non-refundable income tax credits for certain types of employees. I suspect this may be the wrong mechanism. Making the employment credit non-refundable certainly would reduce the immediate cost of the program and avoid breaching the principle of not providing cash subsidies to employers. But it would mean that small start-up businesses, which typically do not have profits on which to pay taxes, would have little benefit from the credit.

Perhaps a better strategy would be to provide tax relief to the employee instead, by using enterprise zones as demonstration areas for an enhanced Earned Income Tax Credit (EITC). The current refundable credit would be both increased and linked to the size of the family, as many lawmakers and policy experts already have proposed in the context of welfare reform. This would mean more take-home pay for lower-paid workers, particularly for those leaving welfare or with large families. The employer would not need to be profitable for this non-refundable tax break to apply. Designing the employment tax relief in an enterprise zone, as a form of an expanded EITC, probably would be more effective than the current legislation's combination of non-refundable credits for both employer and employee.

This renewed interest in passing tax-based enterprise zone legislation is an important step forward in addressing the problems of depressed neighborhoods. The conditions in many areas may be far worse than when the concept was first proposed in the U.S., but there are also grounds to believe the concept might yield better results today. We have learned a great deal in the last ten years about the nature of the problem and the potential for various approaches. Pouring money into the inner cities has not succeeded in the past and there is little reason to believe it would do so in the future. Instead we should launch a strategy based on stimulating the dormant entrepreneurship within depressed areas themselves, combined with steps to empower residents to exercise greater control over their housing and education. Such an approach would be based on the knowledge we have acquired in recent years that improvement in a poor neighborhood can occur only if it is led from within.

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