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NEW LIFE FOR FEDERAL ENTERPRISE ZONE LEGISLATION: SEVEN LESSONS FROM THE STATES

INTRODUCTION

Congress this year will debate legislation that many Americans would say is a decade overdue. Two bills are involved: the Enterprise Zone Tax Incentives Act of 1991 (H.R. 11), and the Enterprise Zone Jobs Creation Act of 1991 (H.R. 23). These would grant significant tax and regulatory incentives to encourage the creation and growth of businesses within the most depressed neighborhoods and areas of America's cities. A Senate bill (S.1032) is identical to H.R. 23. Two more bills, one each in the House and Senate, would provide enterprise zone designation specifically to rural areas.

The first enterprise zone bill was introduced in the House in 1980, co-sponsored by then-Congressmen Jack Kemp, a Republican, and Robert Garcia, a Democrat, both of New York. Despite strong bipartisan congressional support, as well as White House backing, enterprise zone measures granting tax relief to inner city businesses never passed both houses. The only legislation that did emerge from Congress was Title VII of the 1987 Housing and Community Development Act, a shell enterprise zone program designed to provide eligible areas with only a few waivers from U.S. Department of Housing and Urban Development (HUD) regulations.

Seeds of Growth. The premise behind enterprise zones is that many depressed neighborhoods already contain the seeds of development in the form of buildings, labor and—currently misdirected—entrepreneurial talent. Reducing government financial and regulatory barriers to business enterprises, it is argued by proponents, could encourage residents of the neighborhood to engage in legitimate business, and thus would encourage outside investors to risk investing in these areas. The legislation before Congress is intended to remove these barriers.

H.R. 11 is sponsored by Representative Dan Rostenkowski, the Illinois Democrat, who chairs the House Ways and Means Committee. Previously, during legislative conference sessions in 1983 and again in 1984, Rostenkowski was instrumental in killing tax-based enterprise zone legislation which earlier had passed by a wide margin. Thus, his strong support for zone legislation this year could be crucial to its passage. His bill has some good features; it also poses problems. It would add, for instance, burdensome compliance requirements on businesses operating in federal enterprise zones, precisely the kind of regulation that the zone proposal originally intended to end.

No Bogging Down. By contrast, H.R. 23, sponsored by Representative Charles Rangel, the New York Democrat, and a leading House Ways and Means Committee member, would encourage firms to engage in enterprise rather than become bogged down with the compliance burdens that the Rostenkowski bill would create. Significantly, H.R. 23 was submitted by Rangel on behalf of the Bush Administration. The terms "Rangel bill" and "Administration bill" thus refer to the same measure.

The urban-oriented Rangel and Rostenkowski bills both envision a program lasting 25 years. Each has eligibility criteria involving minimum levels of poverty and unemployment in a zone, and each requires that those areas seeking zone status file a "course of action" which lists, among other things, state and local commitments to tax reduction, regulatory streamlining, donations of real property for business use, and local public service improvements.

There are several major differences between the bills. Among them:

- The Rangel bill would phase in 50 new zones over four years; the Rostenkowski bill would phase in only 25 over this period.
- The Rangel bill would set aside one-third of all zone designations for rural areas; the Rostenkowski bill merely would make rural areas eligible for designation.
- The Rostenkowski bill would require localities in their applications to give preference to minority contractors, demonstrate a commitment to producing low-income housing, provide incentives for pooled health insurance for zone employees, and encourage banks to satisfy Community Reinvestment Act obligations. The Rangel bill would impose no such requirements upon localities.
- The Rostenkowski bill would offer companies with under ten employees a 10 percent tax credit against corporate income taxes for wages paid to new employees. The Rangel bill, on the other hand, would provide a 5 percent personal income tax credit for employees.

- The Rostenkowski bill would defer for ten years taxation on capital gains up to $250,000, and would allow losses on zone stock to be deducted from taxable ordinary income. The Rangel bill would exempt some generated capital gains from taxation entirely, but would not allow losses to be deducted from income.
- The Rangel bill would treat purchases of stock in an enterprise zone-based company as a personal income tax deduction. This "expensing" provision allows investors to take a deduction of up to $50,000 annually, with a $250,000 lifetime limit, for investment in zone firms having less than $5 million in assets. The Rostenkowski bill contains no such provision.
- The Rostenkowski bill would set an annual limit of $10 million (adjustable upward based on population and local government expenditures) on the total federal tax loss permissible for each zone. It would mandate that local "zone czars" allocate usable tax credits to participating firms within the cap. The Rangel bill contains no such provision.

As the House and Senate consider the pending enterprise zone legislation, they have the benefit of assessing and learning from nearly ten years of state versions of enterprise zone programs. Since 1982, when Connecticut designated ten zones, and made them eligible for business tax credits and other benefits, 37 states plus the District of Columbia have established and retained their own programs.[1] Going under such names as "enterprise zones," "economic development zones," and "job opportunity zones," these programs focus on tax or other incentives for job growth in the most economically depressed areas. Some state programs, such as those in Georgia, Oklahoma and Tennessee, provide fairly minimal benefits and require minimal government management. Others, such as those in Illinois, Missouri and New York, offer generous benefits but encourage and often require an activist state and local governmental role.

The Bush Administration's bill would build on state enterprise zone experience. Unlike the Rostenkowski bill, the Rangel/Administration bill embodies much of the original vision of the enterprise zone concept. It incorporates many of the most successful features of state programs. Its tax benefits are generous, yet would discourage "tax-shopping," or large firms moving operations from one jurisdiction to another primarily or solely for tax benefits.

While the Rangel/Administration bill is the better of the two, Congress should not rubber-stamp it. Instead, Congress should revise the bill at least to exempt intangible as well as tangible assets from capital gains taxes, and to give preference to states and localities demonstrating a commitment to welfare reform, educational choice and deregulation.

1 One state, Mississippi, enacted legislation but allowed it to expire in 1989.

THE ENTERPRISE ZONE APPROACH

An enterprise zone is an economically depressed area in which costly government tax and regulation requirements are reduced to encourage private businesses to take root or grow. The goal is to make such an area more attractive for private investment and job creation. The assumption is that if private development can be ignited, many of the crime and social problems of the area will start disappearing.

Small, New Firms. According to the original enterprise zone concept, the primary targets of the incentives should not be larger, established firms (many of which do not need such benefits), but smaller and, especially, new firms. Small firms are more likely to take root in a poor, depressed neighborhood, and are more likely to create jobs. The research of Massachusetts Institute of Technology economist David Birch reveals, in fact, that firms with fewer than twenty employees accounted for 88.1 percent of all net new nongovernmental jobs created in the United States during 1981-1985.[2]

The general pattern of job creation noted by Birch is corroborated in surveys of existing state enterprise zones. According to an eight-city study of state enterprise zones performed for the Small Business Administration, zone employment in seven of the cities increased among smaller firms, and stagnated or decreased among larger firms.[3]

Enterprise zones seek to redirect actual or potential illegal and underground entrepreneurship into legitimate enterprise. Every moonlighting employee and black marketeer has the potential to become a small businessman.[4] By reducing the tax and regulatory barriers that have inhibited these businesses from becoming legitimate, enterprise zones would foster new economic activity. This contrasts with most existing government programs, which simply transfer existing business activity into depressed areas. Said Housing and Urban Development (HUD) Secretary Kemp in hearings before Congress in 1989, enterprise zones would "extend growth into those pockets of poverty, urban and rural, that have been left out of the macro-recovery."[5]

Federal enterprise zone legislation, however, has yet to be shaped along these lines. When Congress passed federal legislation four years ago, it included none of the tax incentives that supporters see as indispensable. The Title VII law of

2 David Birch, *Job Creation in America: How Our Smallest Companies Put the Most People to Work* (New York: Free Press, 1987) p. 16.

3 Susan A. Jones, Allen R. Marshall, and Glen E. Weisbrod, *Business Impacts of Enterprise Zones*, prepared for U.S. Small Business Administration (Cambridge: Cambridge Systematics, Incorporated, September 1985).

4 Stuart M. Butler, *Enterprise Zones: Greenlining the Inner Cities* (New York: Universe Books, 1981) p. 164.

5 Statement of Jack Kemp, Secretary, U.S. Department of Housing and Urban Development, in U.S. Congress, Senate, Committee on Small Business, *Enterprise Zone Program and Its Impact on Small Business Growth and Development*, 101st Congress, First Session, Hearings, June 21 and September 21, 1989, Washington, D.C.: U.S. Government Printing Office, 1989, p. 146.

1987 merely authorizes the Secretary of HUD to designate as federal enterprise zones 100 existing state enterprise zones, one-third of them in rural areas. Eligible proposed zones had to demonstrate significant incidence of poverty, unemployment and population decline. Kemp wisely has refused to put the program into effect until Congress adds some financial incentives. He and other proponents of genuine zone legislation understand that it is a hoax to announce to a community that enterprise zones exist, but without any investment incentives.[6]

LEARNING FROM THE STATES

State enterprise zones have been around for nearly a decade. Their experience confirms that permanent urban and rural jobs are created when tax relief is combined with the elimination of local red tape and with steps to encourage community organizations to take part in economic development. State enterprise zone programs by the end of 1988 had stimulated over $18 billion in new investment, created 184,000 new jobs, and saved close to another 170,000 existing jobs.[7]

The zone tax breaks, moreover, have paid for themselves by creating more businesses, and hence a larger tax base. City University of New York Associate Professor of Public Administration and Economics Marilyn M. Rubin estimates that during 1984-1988, New Jersey's enterprise zone program added about $1.90 in tax revenue for every $1 it cost in tax breaks.[8]

The state programs hold many lessons for a federal enterprise zone program. While the performance of state zones does suggest that tax incentives can stimulate business creation in depressed areas, they also suggest that certain kinds of tax breaks work better than others. They indicate too that certain types of neighborhoods are more conducive to growth than others, and that local government must take an active rather than passive role in promoting the attractiveness of a zone as a place to invest.

A review of the successes and failures of state enterprise zone programs can teach lessons to federal as well as state lawmakers.

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6 See statement of Jack Kemp, *ibid.*, p. 71.

7 John Scanlon, "Kemp's 'HOPE' Package: The Start of a Sound Housing Policy," Heritage Foundation *Issue Bulletin* No. 155, March 29, 1990, p. 9.

8 Testimony by Marilyn Rubin in U.S. House of Representatives, Committee on Ways and Means, *Administration's Enterprise Zone Proposal, and H.R. 6, The Enterprise Zone Improvement Act of 1989*, 101st Congress, First Session, Hearings, October 17 and 18, 1989, Washington, D.C.: U.S. Government Printing Office, 1990, p. 283. See also original study, Marilyn M. Rubin and Regina B. Armstrong, *The New Jersey Urban Enterprise Zone Program: An Evaluation* (Wayne, N.J.: Urbanomics, 1989).

Lesson No. 1 - Sales tax exemptions on equipment purchases, real property tax exemptions, and employee tax credits have been the most successful forms of relief used by states to encourage business formation and job creation, particularly in small firms, in areas with substantial poverty and unemployment.

Critics of enterprise zones assume that federal tax benefits would be little more than giveaways to attract or keep in place large companies. Hence, they argue, such tax incentives merely would rearrange existing economic activity. These critics infer that because firms tend to view labor market access, site characteristics and local government cooperation as more important factors than tax breaks, reducing various federal taxes would be a needless and potentially costly way of attracting enterprises. In addition, these critics maintain that tax breaks usually benefit companies that already have shown a profit—mainly established companies—rather than struggling new entrepreneurs whom the zones are intended to benefit most.

Crucial First Years. This argument is misleading. It ignores the fact that certain kinds of tax credits and exemptions help small firms accumulate working capital during their crucial first few years of operation. Tax incentives that avoid complexity (which is an open invitation to creative tax accounting in large firms), that reward firms that start and remain in zones, that apply to equipment and other start-up purchases and that provide relief to employees as well as employers have been especially successful in creating jobs in depressed areas. Virtually every state program uses some combination of corporate income tax credits or deductions, sales tax exemptions, selective hiring tax credits, property tax waivers or reductions and investment tax credits.

Such measures are of particular importance to smaller firms, and much less so to existing large firms. Rubin's study of the New Jersey program, which gives up-front sales tax exemptions and tax rebates for hiring persons on unemployment, indicates that three of every four firms receiving benefits had fewer than fifty employees, with the average participating firm employing sixteen people.[9]

Similarly Chris Cashman, Philadelphia's First Deputy Director of Commerce, reports that his city's enterprise zone program, which among other benefits grants real estate improvement and zone resident tax credits, has been most attractive to manufacturing and warehousing firms with ten to fifty employees.[10]

More generally, HUD has found in a survey of 22 state enterprise zone coordinators that employee tax credits, and sales and use tax exemptions on building materials, equipment and machinery are best for stimulating business growth in distressed areas.[11]

9 Rubin, *Administration's Enterprise Zone Proposal*, Hearings, p. 285.
10 Cashman, *ibid.*, pp. 379-80.

Among the state programs with zones based on this tax strategy:

♦♦**New Jersey's** program offers sales tax exemptions on equipment and materials, exemptions on state corporate income taxes, and an Unemployment Insurance Tax rebate for each new employee making a gross annual salary of less than $18,000. Employers cite the sales tax features as by far the most beneficial to their business. Over $800 million in new investment, creating 9,000 new jobs, has poured into the state's ten enterprise zones.[12]

♦♦**Minnesota's** enterprise zones provide a state tax credit against local property taxes on new or expanded facilities, an income tax credit to help finance construction costs, an income tax credit up to $3,000 for each additional permanent worker hired, and an exemption from state sales taxes for the purchase of construction materials and operating equipment. Through these incentives, Minnesota created 5,200 jobs between 1983 and 1989, and retained about 6,000 to 8,000 jobs each year. Over the five-year period for which businesses could claim credits, each dollar that the state originally lost in tax credits generated $1.17 in new tax revenues from businesses in the zones.[13]

♦♦**Connecticut's** program includes a 50 percent state corporate income tax reduction for ten years for firms hiring 30 percent of their new employees from disadvantaged workers or zone residents, and an 80 percent property tax abatement on land, buildings and machinery for five years. As of mid-1989, the state's zones had attracted about $375 million in private investment, creating more than 6,600 new jobs, and retaining 6,900 other jobs.[14]

Hartford's zone is the most economically distressed among the ten in the state, mainly because of the two public housing projects in the zone. Yet during its first seven years, this zone received some $30 million in new investment, accounting for 1,337 new and retained jobs, and 93 business start-ups and expansions.[15]

Implications for Federal Legislation. This state experience suggests that federal enterprise zone legislation should retain or modify three key incentives:

11 U.S. Department of Housing and Urban Development, *Enterprise Zones in States with Competitive Programs—Performance and Effectiveness: A Survey of 22 State Enterprise Zone Coordinators* (Washington, D.C.: U.S. Department of Housing and Urban Development, Office of Program Analysis and Evaluation, June 1989).

12 Rubin, *Administration's Enterprise Zone Proposal*, Hearings, p. 288; see also Rubin, "Urban Enterprise Zones in New Jersey: Have They Made a Difference?" in *Enterprise Zones: New Directions in Economic Development*, Roy E. Green, ed. (Newbury Park, California: Sage Publications, 1991) pp. 105-21. Overall, including the indirect effects of enterprise zone tax benefits, the program created close to 43,000 jobs.

13 Statement of Louis Jambois, Director of Community Development, Minnesota Department of Trade and Economic Development, in *Enterprise Zone Program and Its Impact*, Hearings, p. 63.

14 *Ibid.* For additional evidence of the success of Connecticut's zone programs, see Cait Murphy, "Connecticut: EZ Does It," The Heritage Foundation: *Policy Review*, Spring 1986, No. 36, pp. 66-70.

15 Statement of Beverley Marshall Dawes, Manager of Hartford, Connecticut Enterprise Zone, in *ibid.*, Hearings, pp. 99-103.

1) **An employee tax credit provision, as the Rangel bill would do, but with an annual wage cap of $15,000 rather than $10,500, as the bill currently proposes.**

The Rangel bill would give employees of enterprise zone firms an income tax credit of 5 percent of their annual wages up to $10,500. Thus, employees who make $10,500 could reduce their income tax by $525; employees who make $8,000 could reduce their income taxes by $400. Because many new employees likely would make wages higher than $10,500, raising the wage ceiling for the credit to $15,000 would provide potential employees with a greater incentive to work for an enterprise zone firm.

The Rostenkowski bill, on the other hand, offers companies with under 100 employees a tax credit of 10 percent on the first $30,000 in wages they pay to a new employee. The credit can be taken against corporate income taxes, and the employer, not the employee, enjoys the credit. This provision likely would be less effective in creating new jobs than the Rangel bill because small new firms typically do not pay corporate income taxes in their early years and so would not be able to use the credit.

2) **Elimination of long-term (more than two years) capital gains taxes on investments within the zones, as the Rangel bill proposes.**

HUD Secretary Kemp repeatedly emphasizes elimination of the capital gains tax as the number-one priority for federal enterprise zone legislation. There is good reason for this, particularly since the 1986 Tax Reform Act raised the top federal rate from 20 to 28 percent. Small firms tend to raise capital from savings, family and friends. Yet would-be entrepreneurs often cannot start businesses, since they lack sufficient savings or access to friends and family with funds. Eliminating the tax on capital gains earned in successful enterprise zone ventures would prompt banks, insurance companies, corporations and other outside investors to view these ventures as more appealing investments.

The federal government thus should eliminate entirely (as proposed in the Rangel bill) taxes on long-term capital gains earned in a federal enterprise zone. Merely deferring such taxes, as the Rostenkowski bill proposes, does not go far enough. The Rangel bill proposes eliminating the tax on the capital gains of all new tangible assets, such as real estate, in the zone for firms eligible to participate. The final bill should go further and make such intangible assets as company stock eligible for such treatment.

3) **Expensing of investment purchases, as provided for in the Rangel bill.**

The Rangel bill allows participating firms to deduct or "expense" at the time of acquisition from their taxable income the full cost of an asset required for that business. Investors can reduce income tax liability up to $50,000 annually, and $250,000 lifetime, by purchasing enterprise zone stock. Currently, the IRS requires that the cost of a firm's plant, machinery and other assets be deducted gradually over many years. For enterprise zone firms, expensing gives small-scale and otherwise potentially risky ventures an immediate tax break that reduces significantly the cost of starting a business or of expanding a business already in a zone.[16]

The Rangel bill thus would provide an important source of seed money for small businesses.

Lesson No. 2 - Hiring workers from low-income areas is easier when non-profit community organizations provide job training, financing and other services.

Because enterprise zones are located in areas with a high number of poor people, often on welfare, the potential work force often lacks the education or training to work for some firms. This plus the absence of financing, labor and technical support can discourage firms using sophisticated equipment and production methods from investing or expanding in zones. When firms located in New Jersey's Urban Enterprise Zones were asked why they did not participate in the zone's program, 41 percent cited the lack of qualified employees; this by far was the most frequent response.[17]

Nonprofit community organizations have proven very helpful in screening and training workers for firms locating in state zones. In some instances, these organizations themselves become employers. Among the better known examples are:

♦♦**In Minneapolis,** a community nonprofit group, Seward Redesign, provides job training and referral services for unemployed and underemployed enterprise zone residents. Companies in target areas agree to hire area residents for entry level jobs at a training wage of approximately five dollars per hour. After the training period, the employer agrees to hire the trainees at the market wage.[18]

♦♦**In Chicago,** the Bethel New Life community development corporation helps the unemployed and welfare population become aware of local zone opportunities, and then trains them for specific careers. Though not necessarily limited to enterprise zones, Bethel New Life places over 500 people a year in full-time employment, half of them former welfare recipients. It also sponsors day care and literacy programs for the poor. Overall, Bethel New Life employs over 350 persons from low-income neighborhoods in the enterprises it has started.[19]

16 Roy E. Green, "Is There a Place in the 1990s for Federally Designated Enterprise Zones within the Context of State-Administered Enterprise Zone Program Experience?" *Journal of Planning Literature*, Vol. 5, No. 1, August 1990, p. 42.

17 Statement of Rubin, *Administration's Enterprise Zone Proposal*, Hearings, p. 287. By contrast, only 13 percent of the respondents said they were unaware of the availability of the benefits.

18 Statement of Iric Nathanson, Finance Coordinator, Minneapolis Community Development Agency, in U.S. Congress, *Enterprise Zone Program and Its Impact*, Hearings, p. 92.

19 Statement of Mary Nelson, President, Bethel New Life, Inc., Chicago, in *Administration's Enterprise Zone*

Implications for Federal Legislation. Both the Rangel and Rostenkowski bills require that localities applying for federal zone designation must indicate if non-profit organizations are providing job training and referral services. The bills would require HUD to rate favorably those applications that include references to local nonprofit groups, such as a Chamber of Commerce chapter or a community development corporation, that offer such services. In addition to this, the final bill should require HUD to rate favorably zone proposals using the federal Homeownership and Opportunity for People Everywhere (HOPE) program to encourage tenant management and purchase of public and subsidized housing. Since poverty is highly pronounced in such housing projects, opportunities for entrepreneurship among the poor are especially abundant here.[20]

Lesson No. 3 - Enterprise zones are successful when the quality of life for residents is high.

Incentives for job creation in a distressed area likely will be weakened if the major sources of distress remain untreated. Where crime, drugs and vandalism run rampant, even the best enterprise zone program may fail. An enterprise zone must be an attractive place in which to live, work and shop.

In an analysis of 357 enterprise zones in seventeen states, Rodney A. Erickson, Director of Pennsylvania State University's Center for Regional Business Analysis, and several of his associates, found that a program's success is strongly related to local efforts to make an area livable and to promote it as such to prospective businesses. After examining the ninety "high performing" zones, the authors recommend:[21]

> [States] should concentrate their efforts on a relatively small and select set of zones that are characterized by genuine development potential....basic labor skills, public infrastructure, and transportation access that can make the areas attractive for investment with the marginal but catalytic contributions that enterprise zone designation, incentives, and visibility can provide.

Warns Erickson: "Enterprise zones as a stand-alone program are unlikely to achieve significant results."[22]

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19 Statement of Mary Nelson, President, Bethel New Life, Inc., Chicago, in *Administration's Enterprise Zone Proposal*, Hearings, pp. 325-327.

20 John Scanlon, "People Power in the Projects: How Tenant Management Can Save Public Housing," Heritage *Backgrounder* No. 758, April 20, 1990, pp. 4-7.

21 Rodney A. Erickson and Susan W. Friedman, "Comparative Dimensions of State Enterprise Zone Policies," in *Enterprise Zones*, Green, ed., p. 175. The article is taken from the original report, Rodney A. Erickson, Susan W. Friedman, and Richard E. McCluskey, *Enterprise Zones: An Evaluation of State Government Policies* (Washington, D.C.: U.S. Department of Commerce, Economic Development Administration, January 1989).

22 Quoted in Eugene Carlson, "Impact of Zones for Enterprise Is Ambiguous," *Wall Street Journal*, April 1, 1991.

Zones with tax-based incentives work best when the incentives are coordinated with efforts to reduce crime, welfare dependency, illiteracy and other factors that make an area unattractive to business. Philadelphia, for example, offers low-interest grants and loans to eligible firms in an enterprise zone to repair streets, expand water and sewer lines and otherwise improve the infrastructure.[23] Bridgeport, Connecticut's success in attracting new investment to its zone is due partly to the city's support of merchant and resident associations in ongoing neighborhood revitalization efforts.[24]

Likewise, the success of St. Louis's program is due in part to publicly and privately-funded infrastructure improvements.[25]

Gaining Confidence. Firms note that even the designation of an area as a zone produces a positive feeling about the area. This gives firms confidence to locate or expand. Example: Triplex, Incorporated, a family-run business in an enterprise zone in Michigan City, Indiana, explains that the main factor prompting it to invest $300,000 in its facility was the perception that others in the city had begun to care about the area. After expanding its operations in the zone, Triplex found its business increased and ultimately hired ten new employees, boosting its workforce to 35.[26]

Richard H. Cowden, Executive Director of the American Association of Enterprise Zones, a Washington, D.C.-based trade association of state and local governments and private sector organizations, cites numerous examples of states using enterprise zone incentives to stimulate neighborhood improvement programs. These include resident crime watches, storefront renovation grants, and local government donations or low-rent leases of usually vacant buildings to new firms.[27]

Special Care. These vacant premises often are called "incubator" buildings and merit special consideration by zone advocates. Such buildings are owned by established companies. These companies provide space and support for technical services, like secretarial and accounting help, for new firms that otherwise might not be able to pay market rents for commercial space or to hire support personnel for their own businesses.

This low-rent physical plant reduces front-end expenditures in capital, equipment, staffing and services, and thus enables a firm to survive as in an incubator, in its precarious early years. As a result, while some 80 percent of new businesses

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23 Statement of Cashman, *Administration's Enterprise Zone Proposal*, Hearings, pp. 377-80.

24 U.S. Department of Housing and Urban Development, *State-Designated Enterprise Zones: Ten Case Studies* (Washington, D.C.: U.S. Department of Housing and Urban Development, Office of Community Planning and Development, August 1986) p. 13.

25 *Ibid.*, p. 128.

26 *Ibid.*, pp. 162-63.

27 Statement of Richard H. Cowden, Executive Director, American Association of Enterprise Zones, *Administration's Enterprise Zone Proposal*, Hearings, pp. 208-12.

nationwide fail within their first three years, nearly 95 percent of new businesses located in incubators survive for at least five years.[28]

In Louisville's enterprise zone, for example, the city helped the owner of a vacant shopping center convert it into a 40,000 square-foot incubator facility. The building houses, at modest rents, wholesalers, contractors, salespersons and manufacturers' representatives.[29]

Implications for Federal Legislation. Both the Rangel and Rostenkowski bills give preference in the zone selection process to localities committed to upgrading public services. The bills would be improved by giving weight to high-quality police service. No low-income, high-crime area or neighborhood can rebound from poverty unless street crime is dramatically reduced.[30] Additionally, the availability of usable vacant industrial and office space should be an explicit consideration in application reviews.

Lesson No. 4 - Programs work best when the number of zones is kept low and when zone selection is competitive.

Strong supporters of tax and financing incentives for federal enterprise zone legislation wisely recommend limiting the number of zones.[31]

Too many zones would dilute their effect and remove the competitive incentive for state and local governments to pursue the necessary policies to complement federal incentives. Some states, such as Florida, Louisiana and Ohio, have created a large number of zones. Louisiana alone has designated 700 zones, covering some 60 percent of the state's area. This undermines the enterprise zone concept.

Implications for Federal Legislation. To encourage states to compete for federal zone designation, Congress should limit the number of zones. Congress should create 100 enterprise zones during the first four years of the federal program. This is twice the number in the Rangel bill, and four times the number in the Rostenkowski bill, yet less than an amount that can be considered excessive. In selecting federal zones, Washington should give preference to areas already operating as zones under state programs, without necessarily excluding adjacent areas.

Lesson No. 5 - Incentives for business creation are of little use if entrepreneurs are suffocated by red tape before they even start a business. The best state zone programs streamline

28 U.S. Department of Housing and Urban Development, *State-Designated Enterprise Zones*, p. 90.

29 *Ibid.*

30 Carl F. Horowitz, "An Empowerment Strategy for Eliminating Neighborhood Crime," Heritage *Backgrounder* No. 814, March 5, 1991.

31 Statement of David R. Burton, Manager, Tax Policy Center, U.S. Chamber of Commerce, *Administration's Enterprise Zone Proposal*, Hearings, pp. 212-13.

the procedures associated with obtaining permits to start a business.

A main reason for enterprise zones is that excessive regulation and the time required to obtain necessary permits discourages entrepreneurs from starting or expanding businesses. This hurts small businesses most. It is they who least can afford delay and the costs of complying with land use, labor and other standards. Such regulation unwittingly inhibits most job growth in low-income urban neighborhoods whose would-be business owners are black or Hispanic.[32]

Currently, about twenty state zone programs relax some state and local rules and controls. Where states have not done so, the enterprise zone programs are less effective than they could be. Wright State University economist Sam Staley finds in his study of the Dayton, Ohio, zone program numerous employers complaining of the delays and other costs of excessive regulatory and paperwork hurdles in obtaining tax relief. While many new jobs have been created in the zone, Staley concludes that there would be more had Ohio's enterprise zone law shortened and simplified application procedures to obtain local permits.[33]

The states and cities that significantly have trimmed regulations include:

♦♦ **Texas,** which reduced the time it takes to process air and water permit applications from nine to three months for enterprise zone participants. This was a crucial factor in persuading Trinity Industries, a Dallas-based rail car manufacturer, to invest $10 million in a vacant steel plant in the Beaumont zone previously occupied by Bethlehem Steel.[34]

♦♦ **Louisville,** which adopted a new flexible land use zoning district (called "EZ-1") solely for use in the zone. By expanding the number of purposes for which land in the zone can be used, by eliminating the expanded range of permissible land uses in the zone, and eliminating the rezoning application process which had taken six months, the city has made it easier and faster for firms to locate or expand in the zone.[35]

Implications for Federal Legislation. Both bills correctly would require HUD to favor local applications for enterprise zone status that propose a strategy to reduce or waive permit requirements. The bills also should encourage what is commonly known as "one-stop" permitting, whereby a firm can acquire from a single government agency all permits necessary to begin a business.

32 See Peter Bearse, *A Study of the Impact of State and Local Regulation on Small and Minority Business Enterprise* (Washington, D.C.: U.S. Department of Commerce, Minority Business Development Agency, July 1988).

33 Sam Staley, *Can Enterprise Zones Revitalize the Central City? An Ohio Case Study* (Dayton: Urban Policy Research Institute, February 1991).

34 Statement of Karin Richmond, President, Texas Association of Enterprise Zones, *ibid.*, p. 253.

35 U.S. Department of Housing and Urban Development, *State-Designated Enterprise Zones*, p. 92.

Lesson No. 6 - The most successful state programs encourage or even require local governments to provide technical assistance to firms in zones and to advertise zones to attract entrepreneurs.

A 1986 HUD study of ten state zones found that aggressive local advertising is a catalyst for business creation and job growth in zones.[36]

This is confirmed in a 1990 four-state study by Wayne State University economist Richard Elling and sociologist Ann Sheldon. They write: "Administrative resources matter more than any other factor in our...analysis. Staff that can undertake marketing efforts, meet with firms, and provide supplemental services increase the utility of the traditional incentives that reduce business costs."[37]

Erickson, Friedman and McCluskey in their multi-state analysis also note that local marketing to the business community is critical to a zone's success.[38]

Local Persuasion. Localities thus can make the crucial difference in persuading firms to participate in an enterprise zone program. The zone program in New Haven, Connecticut, for example, is successful largely because of aggressive promotion by the local government. Working in conjunction with the Connecticut Department of Economic Development, Yale University, and the Olin Corporation, New Haven created Science Park, an 80-acre high-tech and light industrial park that includes two business incubator structures. City officials aggressively marketed the science-based zone, eventually attracting some 85 entrepreneurs to the incubator buildings, and then giving them technical support to enable them to grow.[39]

Kentucky's program, which has seen over 1,000 businesses and 8,000 jobs established in the state's ten zones since 1982, has used surveys as a means of attracting enterprises. The state enterprise zone coordinator's office asked residents of the Louisville zone, for instance, what kinds of new businesses they wanted in their area. Overwhelmingly, residents said that they wanted a supermarket. The state and city then approached food retail chains and explained to them the incentives of opening an outlet in the zone. The result was two supermarkets operating in the zone.[40]

36 *Ibid.*

37 Richard C. Elling and Ann Workman Sheldon, "Determinants of Enterprise Zone Success: A Four State Perspective," in *Enterprise Zones*, Green, ed., p. 151. See also original study, Ann Workman Sheldon and Richard C. Elling, *Enterprise Zones in Four States: Pànacea or Placebo?* (Detroit: Wayne State University Center for Urban Studies, 1990).

38 Erickson, Friedman, and McCluskey, *Enterprise Zones*; Erickson and Friedman, "Comparative Dimensions of State Enterprise Zone Policies," p. 174.

39 Murphy, "Connecticut: EZ Does It," p. 67.

40 Karen Diegmueller, "Enterprise Zones in No-Man's-Land," *Insight*, May 1, 1989, p. 24.

Implications for Federal Legislation. In evaluating proposals, the federal government should give special consideration to applications in which localities promise to publicize the zone and to assist the firm. Neither bill in its present form explicitly does this.

Lesson No. 7 - Enterprise zone designation can help rural as well as urban areas, mainly by keeping jobs in the area.

States typically designate rural areas as enterprise zones to keep factories and other manufacturing facilities from leaving the area.[41] A commonly cited example of this job retention strategy for rural zones is Thief River Falls, Minnesota —a heavily industrial area with several small towns nearby. The designation of much of the community as an enterprise zone allowed almost 600 workers threatened with layoffs to keep their jobs.

Implications for Federal Legislation. Enterprise zone bills aimed specifically at rural areas have been introduced in the House (H.R. 1445), co-sponsored by Byron Dorgan, the North Dakota Democrat, and Fred Grandy, the Iowa Republican, and in the Senate (S. 686), sponsored by Max Baucus, the Montana Democrat.[42]

The Rangel bill already sets aside at least one-third of all zone designations for rural areas; the Rostenkowski bill, while containing no set-aside, would make rural areas eligible for designation. Because the Rangel and Rostenkowski bills thus cover rural areas, there is no need for separate bills to do so.

THE WEAK CASE AGAINST ENTERPRISE ZONES

Despite the impressive track record of state enterprise zone programs, some observers maintain that the zones have not worked, and will not. These critics typically argue that the zone strategy merely shifts around existing economic activity. They argue too that the tax and regulatory incentives have had marginal impact and that a successful program needs extensive government regulation and services. Among the studies of state zones:

1) General Accounting Office.[43]

In response to a request by then-New York Representatives Jack Kemp and Robert Garcia for a case study, the General Accounting Office (GAO) examined the performance of Maryland's enterprise zone program between December 1982 and September 1987. The report appeared in 1988 and, while acknowledging

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41 Conversation with Michael Savage, Aide, U.S. House of Representatives, Committee on Government Operations, May 20, 1991. (Savage is one of the nation's leading authorities on enterprise zones.)

42 Testimony of Representative Dorgan, *Administration's Enterprise Zone Proposal*, Hearings, p. 120.

43 U.S. General Accounting Office, *Enterprise Zones: Lessons from the Maryland Experience*, GAO/PEMD-89-2, December 1988.

some benefits from the program, generally questioned the program's effectiveness. This is, by far, the evaluation of a state enterprise zone program most cited on Capitol Hill.

Analyzing Factors. The GAO focused on Maryland's program because it seemed to resemble tax-based federal legislation proposed at the time, and because the Maryland zone had been in effect for four years, considered long enough to assess the program's effects. The GAO compared before-and-after employment and welfare recipient levels in three Maryland communities with zones (Cumberland, Hagerstown and Salisbury), each with fewer than 50,000 residents outside a metropolitan area and each suffering double-digit unemployment. GAO also surveyed about 500 employers not participating in the enterprise zone program in these communities, and in the Baltimore and Cambridge zones, asking them which factors most likely would induce them to move to an enterprise zone.

The study concludes that the new jobs created in these areas were due to factors other than program incentives. Some 60 percent of zone employers (whether or not they participated in the program) told the GAO that favorable tax and financing features were of "little or no importance" in a business location decision. The GAO also found that welfare levels did not drop during the period examined.

Some lawmakers cite the GAO report as a refutation of the enterprise zone approach. This overlooks other key points in the study. Among them:

- Some 14 percent of zone employers interviewed regarded tax and financing incentives as being of "great" or "very great" importance to their interest in the zone.
- Employers who did receive zone benefits rated between 60 percent and 90 percent of the incentives as "important." They gave particularly high marks to the property tax credits.
- There also were some methodological problems with the GAO study. Changes in employment and welfare recipient levels were measured in small and declining non-metropolitan communities. This means that the gain or loss of just one large industrial employer statistically can skew the results. Moreover, the survey did not focus on the Baltimore zone, a site more typical of those seen by zone advocates as an appropriate location for a federal zone.
- Most importantly, the resemblance between the Maryland program and the enterprise zone legislation then before Congress was more apparent than real. The federal bill at that time offered: a 10 percent investment tax credit for newly-constructed buildings; exemption from capital gains taxes on business property; a deduction for the purchase of stock in an enterprise zone firm; suspension of the limitation on tax deductions for property financed with industrial revenue bonds; and ordinary loss deductions for securities used to capitalize enterprise zone businesses. The Maryland program contained none of these incentives.

Significantly, the GAO study does not harshly criticize the Maryland program, although enterprise zone critics complain that it does. The study in fact suggests that with some changes the program could work well. The study also highlights the importance of quality-of-life and business climate factors as keys to success—precisely the elements proven crucial ingredients in other states.

2) The Urban Institute.[44]

Urban Institute Research Assistant Bret Birdsong in 1989 reviewed studies of state programs and evaluated the likely effects of the Bush Administration 1989 proposal to create fifty enterprise zones. This proposal was virtually identical to the current Administration bill. Birdsong faults enterprise zones as being costly, poorly targeted toward the poor, likely to distort competition between firms and subject to political logrolling. He concludes, without justification, that at most 1.5 percent of America's poor would have benefited from the Administration proposal. The enterprise zone approach is irrelevant, argues Birdsong, because the problem is not a lack of job opportunities, but a lack of education, health care, literacy and nutrition—items which enterprise zones allegedly ignore.

Birdsong misrepresents the intent of enterprise zones. They do not aim to solve all urban problems. They do aim to spur economic activity as one element of a comprehensive anti-poverty strategy. His premises are also flawed. Example: He assumes that no one living outside zones could benefit from the new businesses created in the zones. It is from this premise that he reaches his conclusion that no more than 1.5 percent of the poor would be helped by zone legislation. What his premise ignores is that a bustling enterprise zone can boost economic activity in adjacent areas, just as a declining neighborhood can pull down its adjacent neighborhoods. Thus, the zones help families and businesses beyond their borders.

3) Purdue University.[45]

Economist James Papke, Director of Purdue's Center for Tax Policy Studies, has analyzed Indiana's enterprise zone program. Studying local unemployment, payroll, and tax assessment records in Indiana during 1981-1989, both inside and outside enterprise zones, Papke concludes that the zones' tax incentives are "expensive, regressive, and ineffective," functioning as little more than bribes to compensate employers for investing in unattractive areas. Papke found that participating firms cut their annual tax bills by an average of $14,000 (primarily through an inventory tax credit); larger firms benefited more than smaller ones; and zone residents made up only 15 percent of new hires in participating firms.

Secondary Effects. His study has several flaws. Example: Papke views reductions in tax bills as "giveaways," as if there were no economic benefits or future tax revenues as a result of new zone investment or job creation. Unlike Marilyn

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44 Bret C. Birdsong, *Federal Enterprise Zones: A Poverty Program for the 1990s?* Discussion Paper (Washington, D.C.: Urban Institute, October 1989).

45 James A. Papke, *The Role of Market Based Public Policy in Economic Development and Urban Revitalization: A Retrospective Analysis and Appraisal of the Indiana Enterprise Zone Program*, Year Three Report (West Lafayette, IN: Purdue University, Center for Tax Policy Studies, August 1990).

Rubin's study of New Jersey zones, Papke did not look at the secondary effects of new zone investment or job creation. He wrongly assumed that new jobs created by tax incentives did not lead to jobs in nonparticipating firms. This explains his unusually high tax cost-per-employee figures.

Papke's findings are undercut by other studies. A 1986 study of the Michigan City, Indiana, enterprise zone by HUD found that tax credits induced a number of small employers to move into the zone, or if already there, to expand their operations.[46]

Papke did not conduct any interviews with firms. Had he, he might have heard from such business leaders as an executive of the New York-based Hudson Valley Tree Incorporated, who attributed the company's decision to build a plant employing up to 600 employees in Evansville, Indiana to the state's zone tax incentives.[47] A 1989 study of Evansville's local program, meanwhile, found that zone designation had been responsible for a substantial amount of job creation.[48] And Wayne State University political scientist Richard Elling and sociologist Ann Sheldon, although generally critical of state enterprise zones, found that an average of 32 firms invested in each zone in each year, a figure well above that of three other states they examined.[49]

4) Wayne State University.[50]

Elling and Sheldon's 1990 study of 47 enterprise zones in Illinois, Indiana, Kentucky, and Ohio concludes that zone designation has not created as many jobs as had been predicted by local officials.The authors blame the lack of a visible and aggressive local government campaign to promote the zones. They also argue that availability of low-cost financing, access to venture capital, less red tape and property tax reductions would have been helpful. Other studies show, in fact, that low-tax zones with these features are more successful than those without. The Elling and Sheldon study thus bolsters the argument for including these elements in a program; it does not undercut the case for zones.

5) David Osborne.[51]

Urban affairs writer David Osborne in the April 3, 1989, issue of the *New Republic* reviewed the enterprise zone studies. He concluded that the tax reductions granted to firms in the state zones failed to live up to their promise. Rather than tax incentives, Osborne said that zones should offer more job training, health care, transportation and other government services.

46 U.S. Department of Housing and Urban Development, *State-Designated Enterprise Zones*, pp. 162-64.

47 Carlson, "Impact of Zones for Enterprise."

48 Barry M. Rubin and Margaret Wilder, "Urban Enterprise Zones: Employment Impacts and Fiscal Incentives," *Journal of the American Planning Association*, Vol. 55, No. 4, Autumn 1989, pp. 418-31.

49 Elling and Sheldon, "Determinants of Enterprise Zone Success," p. 141.

50 *Ibid.*

51 David Osborne, "The Kemp Cure-All," *New Republic*, April 3, 1989, pp. 21-25.

Osborne apparently assumed that enterprise zone programs are intended to be a comprehensive urban policy and anti-poverty strategy. Like Birdsong, he misrepresents the concept. To Kemp and others who promote enterprise zones, the concept is just one important tool in an anti-poverty strategy that expands the choices of the poor rather than the power of the welfare and economic development bureaucracies.

CONCLUSION

It is time for Congress to add some muscle to the current bare bones federal enterprise zone program. The legislation Congress enacts to do this should reflect the best features of the bills before it, the lessons of the most successful state programs, and the principles of the original concept. Among the key points for lawmakers as they fashion a bill:[52]

- Zones should be in areas with available vacant building space to allow new, small-scale business activity. New firms typically do not have the capital to construct new buildings, nor in most instances do they require them. Vacant building space available at low rents are potential incubators for small, indigenous enterprises.
- Government must not try to micromanage economic development within the zones. To be sure, for enterprise zones to work well there must be some government-driven revitalization going on in the area. And government should promote the zones. Yet by trying to pick winners and losers, as the Rostenkowski bill in practice would do, government would be defeating the intent of the enterprise zone, which is to spur creativity by clearing away tax and regulatory obstacles to the entrepreneur, not telling him how to run his business.
- Tax credits for employees are a better inducement to new business formation than tax credits for employers. Employee credits provide an incentive for low-wage employees and the unemployed, while enabling employers to pay lower wages to new hires.
- Tax benefits for small business owners and investors should be kept simple. New businesses typically do not show a profit until after several years of operation, so reducing taxes on profits would benefit them little. Eliminating capital gains taxes on zone businesses, on the other hand, would help new firms by encouraging outside investors to put money into the companies. In addition, with taxes on capital gains eliminated when business owners ultimately sell their companies, the owners have a greater incentive to work hard through the early years to build up their businesses. The total tax benefits

52 These points are also discussed in Stuart M. Butler, "How to Design Effective Enterprise Zone Legislation," Heritage Foundation *Lecture* No. 215, 1989.

available to any one company should be modest to discourage "tax shopping" by large firms considering relocation.

- Enterprise zones are not a comprehensive urban or anti-poverty program, and should not be judged or designed as such. They are a key component in any strategy to revive decaying areas and neighborhoods. Thus, the enterprise zone program should go hand-in-hand with other reforms.

For a decade, Congress has been on the verge of creating an enterprise zone program with tax incentives. Perhaps realizing that the current federal program is so limited as to be virtually useless, lawmakers now seem poised to create a federal program with strong tax incentives. This has won broad bipartisan support, and at all levels of government.

The experiences of over three dozen states are good lessons on what works and what does not work in an enterprise zone program. Congress now should catch up with the state legislatures, and enact a real enterprise zone program that incorporates what works in the states into a federal program that can give a powerful boost to successful state zones.

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APPENDIX

Following is a list of experts and organizations that support tax-based federal and state enterprise zone legislation.

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