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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:

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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.