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ENTERPRISE ZONE UPDATE

INTRODUCTION

In his televised address to the nation just before the November elections, Ronald Reagan declared that passage of an enterprise zone bill was among his top priorities for the lame duck session of Congress.

Ever since he first announced commitment to the concept during the 1980 presidential campaign, Reagan has pressed for congressional action on the proposal, which is designed to revive inner city communities through the removal of government barriers to business enterprise. After considerable delay, caused mainly by disagreements between the Departments of Housing and Urban Development and Treasury, the Administration sent its legislative proposals to Capitol Hill in March 1982.[1]

The Enterprise Zone Tax Act (H.R. 6009, S.2298) won the sponsorship of many legislators who had introduced their own versions of the concept--most notably Congressmen Jack Kemp (R-N.Y.) and Robert Garcia (D-N.Y.) By October it had attracted 129 bipartisan co-sponsors in the House and 28 in the Senate.

Yet the measure has languished in Congress. Despite its wide support among House Democrats, not a single Democrat on the House Ways and Means Committee has co-sponsored the bill, and no formal hearings have been scheduled. As the Congressional Quarterly surmised, it appears that Committee leaders were "not anxious to hand Reagan another victory" before the November elections.[2]

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1 For an analysis of the proposal, see "The Enterprise Zone Tax Act of 1982: The Administration Plan," Heritage Foundation Issue Bulletin No. 80, March 29, 1982.

2 Congressional Quarterly, October 9, 1982, p. 2638.

More surprisingly, Senate action on the President's plan was confined to hearings before a subcommittee of the Finance Committee. Supporters of the enterprise zone idea suggest several reasons for the inaction. Partly, they say, it is due to skepticism concerning the idea by Finance Committee Chairman Robert Dole (R-KS); partly because major tax bills before the Committee pushed the zone bill down the list of priorities; and partly because the White House was not prepared to give it sufficient backing. Zone advocates maintain that White House support was badly weakened by Treasury footdragging and because officials failed to recognize that the enterprise zone proposal could be the key to improving Reagan's very weak standing among minority voters.

When the Senate Finance Committee finally did begin to act on the bill, it was too late to send it to the floor for a vote before the November elections. In the mark-up process, only a few minor changes were made. These included dropping the 5 percent income tax credit of zone employees, pushing back the date for the first enterprise zone designations to July 1983 and the operation of the tax incentives to 1984, and the earmarking of 8 out of 25 annual designations for rural areas. Among the amendments rejected by the Committee, under pressure from the Treasury, was a proposal to allow investors in enterprise zone firms to deduct the entire investment, subject to a limit, from their personal or corporate taxable income.

Given the pressing need to generate genuine new private-sector jobs in the American economy, and the equal importance of tackling the plight of the inner cities with a fresh approach, Congress should give speedy attention to the enterprise zone concept. The Administration should demonstrate that the enterprise zone once again is a White House priority by negotiating forcefully and seriously with the Hill leadership.

In pressing for the proposal, however, legislators should not lose sight of the objectives and rationale of the concept. There are strong signs already that urban lobbyists and interest groups are seeking to turn an essentially simple, private-sector, experimental approach to urban development into a Christmas tree of special federal handouts to the cities. This must be resisted. It would be better to have no enterprise zone program at all than to pervert the original idea--enterprise zones in name only.

THE CONCEPT

To determine the appropriate elements of an enterprise zone package, it is important to remember the foundations of the concept. It is against these foundations that congressional action should be judged.

a) Experimentation

The enterprise zone was conceived as an experiment, based on the premise that the principal reason for inner city blight is that government rules and taxes have halted the natural process of economic adaption, and that they have frustrated innovation and the entrepreneurial spirit. By reducing these barriers to risk-taking and change, argue zone proponents, the dormant potential of these communities would be unlocked, leading to the type of trial-and-error economic and social development which built the cities in the first place, but which well-meaning planners abhor. Just as the enterprise zone concept encourages risk-taking and experimentation, the program itself should be seen as risk-taking in public policy. Given the dire predicament of the inner cities, the federal government should be prepared to consider unusual approaches, in line with the broad strategy of reducing government-inspired barriers to creativity.

b) Creating a Friendly Climate

The enterprise zone aims at creating a climate favorable to entrepreneurial activity. This vastly improves the chances that the best range of businesses will emerge compared to what happens when government supports specific ventures. It hence would be contrary to the zone concept for government to try to "second-guess" the likely development of a zone by channeling grants and assistance to favored companies. Moreover, it can be argued that some of the problems of inner city neighborhoods are, in fact, due to undesirable and unproductive projects that were created to meet the specifications of a federal grant rather than the conditions of the community. The absence of new federal outlays in an enterprise zone is more likely to assist sensible development than to hinder it.

c) Small, New Ventures[3]

Since the enterprise zone is to revive inner city neighborhoods by encouraging the best use of physical and human resources in the community, the emphasis should be on small rather than large firms. Small firms fit into existing buildings; they can get by with adequate rather than top-notch infrastructure; and they tend to require hard work and versatility in an employee, rather than specialized skills.

Small, young firms are essential also because they are the principal generators of net new jobs in the economy, and the most likely to develop services and goods that fit the resources of the inner city and the needs of its potential markets.[4]

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3 For a more extensive discussion of the key role of small firms in job generation and social stabilization in urban areas, see Stuart Butler, Enterprise Zones: Greenlining the Inner Cities (New York: Universe Books, 1981), Chapter 3.

4 Ibid.

New firms are central to the idea for a third reason. Unlike state policies which seek to lure firms to one city from another--to shuffle around existing businesses and jobs for the benefit of targeted areas--the enterprise zone concept aims at stimulating new economic activity in the inner cities. It does not try to rob Peter to pay Paul, or to rob Long Island to aid the Bronx.

For these reasons, the strategy of regulatory and tax relief in an enterprise zone program must concentrate on the needs of the small entrepreneur rather than the big corporation.

d) Local Content

This emphasis on small ventures is consistent with the zone objective of strengthening the local economy for the benefit of residents. There is little point in a "revitalization" program which leads to the physical destruction of a neighborhood to provide space for a major factory if the skills required preclude the recruitment of labor from the community, and if those making profits from production and increased land values reside elsewhere. To ensure that development aids residents, rather than outsiders, an enterprise zone program must focus on establishing a climate that will generate a high proportion of locally owned firms so that residents have a direct stake in the economic process. And that means small firms; people in low income neighborhoods do not start Fortune 500 companies.

The local aspect is important for another reason. The enterprise zone concept is based on the principle that Washington does not know best, and that the last thing blighted areas need is yet another program designed in the Capitol and parachuted into the cities. Instead, the federal role is seen as giving a shot in the arm to innovative state and local initiatives by adding federal tax relief and deregulation. So the underlying momentum of the enterprise zone must come from the neighborhoods, cities and states involved, and not the federal government.

e) The Social Climate

The final, critical element of the enterprise zone concept is the removal of regulatory barriers to neighborhood service organizations.

One of the principal reasons why companies do not start up in places like the South Bronx is the costs and fear associated with high crime and poor social services. The evidence suggests that neighborhood organizations, churches, and other voluntary associations are far more effective at tackling these basic inner city social problems than social welfare professionals, and some neighborhood groups have scored dramatic successes at dealing with inner city crime.[5] The trouble is that the efforts of such

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5 For a discussion of the potential of neighborhood associations in inner cities, see Neighborhood Groups and the Enterprise Zone (Policy Dispatch #2, National Center for Neighborhood Enterprise, Washington, D.C., 1982).

organizations often are frustrated by professional licensing requirements, zoning and other regulations which prohibit volunteers from providing services within their own communities.[6] If enterprise zones are to be successful, then, they must be seen not only as vehicles to generate inner city business, but also as mechanisms to stimulate the proven entrepreneurial powers of neighborhood organizations. That means the regulatory impediments to community-based associations must also be scrutinized carefully.

THE SHAPE OF LEGISLATION

Given the objectives of the enterprise zone concept, and the reality of inner city economic developments, it is clear that any program passed by the Congress must have certain key features if it is to succeed.

a) A Limit on the Number of Designations

The designation of a community as an enterprise zone must not be guaranteed merely by meeting certain eligibility requirements. The number should be limited because the program is an experiment. A limit is also necessary to encourage competition between cities. Many cities will only consider changes in frustrating local laws and regulations that impede market forces if they are pressured by competition to do so. The 75-zone limit in the Administration's bill (25 for each of three years) has broad support and should not be expanded.

b) Privatization and the Encouragement of Neighborhood Organizations

The Administration bill provides that in the designation process, priority will be given to proposals from applicant cities which demonstrate a willingness to contract out services to the private sector, and to encourage neighborhood participation. This provision is critical to the success of the zones and must be retained. It should be made clear to cities, however, that they will be expected to take the provision very seriously and dismantle regulatory barriers facing neighborhood groups engaged in economic development and service delivery.

c) Tax Incentives and Small Firms

The defect in the Administration's bill cited most often by experts in neighborhood economic development is the package of tax incentives. Stated simply, the Administration's thesis is that the best way to stimulate new business formation is to

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6 Ibid. See also Robert L. Woodson, "The Importance of Neighborhood Organizations in Meeting Human Needs," in Jack A. Meyer (editor), Meeting Human Needs (Washington, D.C.: American Enterprise Institute, 1982).

provide non-refundable tax credits for labor and capital employed in the zone.[7] Small business groups note, however, that because most new, independent firms make little or no profit in their early years, the credit would have no immediate value. Firms would face a Catch-22 situation. In order to use credits designed to help them start and prosper, they would have to be prosperous in the first place. Small businessmen point out that their biggest headache when they begin is attracting capital--especially in high-risk inner city areas. The least of their worries is corporate income tax.

A new provision to meet this defect was discussed in Congress but was rejected in the Senate Committee markup. Known as the "expensing" provision, it was supported by several co-sponsors of the Administration's plan and many businesses and organizations engaged in community economic development, such as the National Congress for Community Economic Development (the association for community development corporations) and Control Data Corporation.[8]

Under such a provision, purchasers of new stock in small, young enterprise zone firms would be able to "expense" the investment--deduct the entire investment from their taxable income (as taxpayers can treat contributions to an IRA). There would be a ceiling on the total deduction any taxpayer could take (say, $25,000), and on the total amount of tax-deductible stock any firm would offer (say, $100,000). If the investor were to sell his investment before a minimum period (perhaps three years), he would pay a painful tax penalty. Moreover, that purchaser could not deduct the investment. Some proponents of this provision suggest that the investor should pay income tax on the original value of the stock when it is ultimately stock, meaning that income taxes are merely deferred (again, just like an IRA), while others argue that there should be no tax liability.

The rationale for this provision is that it deals with the real problems of new firms (acquisition of capital) by giving an incentive to the investors, instead of the company. The low ceiling on the deduction would prevent large investors from taking excessive advantage of the provision. Small individual investors, moreover, are generally more inclined to take risks than large lending institutions. The restriction on the issuance of deductible stock would make it of little use to a major corporation. Hence, it would be targeted to new, small companies and their traditional backers.

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7 Non-refundability means that if the available credits exceed the company's income tax liability, it will not receive a credit from Treasury for the balance. If a company does not show a profit, therefore, it cannot utilize the credits.

8 See testimonies before the Subcommittee on Economic Stabilization of the House Banking, Finance, and Urban Affairs Committee, July 13, 1982, and before the Subcommittee on Savings, Pensions and Investment Policy, Senate Finance Committee, April 21, 1982.

The Treasury has opposed vehemently this expensing provision, arguing that it would encourage all manner of tax avoidance schemes. Officials have rejected totally the opinions of small businessmen and inner city development organizations, who maintain that some version of expensing is essential if the zones are to reach the Administration's own objectives. Administration tax experts prefer instead their own theories of the development process within inner city communities.

While any new tax mechanism may, of course, lead to some distortions, Congress nonetheless should add an expensing provision to the final legislation. First, small businessmen know more about the reality of starting small firms in the inner city than do Treasury officials, and businessmen claim that the expensing provision is critical. Second, the ceiling on the deduction can be very low, which would reduce the attractiveness of tax avoidance schemes while targetting the deduction more accurately toward small firms. Third, since the provision aims to generate start-up finance, it could be enacted for a two or three year experimental period, and terminated if it is then deemed not to be cost-effective. Experimentation of this kind is in the spirit of the zone concept.

Finally, Treasury has ignored a similar expensing program that was introduced in Britain last year. The British allow taxpayers to deduct up to the equivalent of $20,000 from taxable income, for each of three years, for purchases of new ordinary stock in a business less than five years old. The opportunities for abuse, so feared by U.S. Treasury officials, are dealt with by the British with simple and enforceable rules. Although the British program was only introduced in 1981, it has worked so well that the government doubled the permissible annual deduction this year. Perhaps Washington should contact London for advice.

CONCLUSION

Congress is facing mounting pressure for a program to generate jobs in the most depressed parts of the nation. The dismal situation of America's inner cities has shown no signs of significant improvement--despite billions of dollars of well-meaning aid being poured into neighborhoods.

The enterprise zone awaits congressional action. It has been frustrated by House footdragging and by the lack of Administration resolve. It is an experiment offered at a time when it has been demonstrated that the traditional urban economic medicine does not work. The U.S. must take new approaches. The Administration must demonstrate to the poor and minorities of America that free enterprise works for them. Congress should act quickly.

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