HOW THE SENATE SHOULD STRENGTHEN THE ENTERPRISE ZONE BILL

The Senate Finance Committee is due this week to mark up legislation to create enterprise zones in blighted communities. The House earlier this month approved a $14.5 billion omnibus tax package (H.R. 11) that, among other things, also would establish federal enterprise zones. The zones would grant tax incentives and regulatory relief to entrepreneurs investing in depressed areas, and are a crucial and long overdue tool to revive these neighborhoods. Yet the zone provisions in the House bill fall short of what is needed for enterprise zones to be effective. The Senate should avoid such mistakes when it takes up H.R. 11.

Some three dozen states since 1982 have enacted their own enterprise zone legislation. While the results of state zone programs have been gratifying, with about $28 billion in new investment, local zone managers rightly claim that powerful federal incentives are needed for enterprise zones to have a decisive impact on depressed neighborhoods. Such federal incentives were deemed essential by enterprise zone proponents as far back as 1980, when Housing and Urban Development (HUD) Secretary Jack Kemp, then a Republican Congressman from New York, along with then-Representative Robert Garcia, a New York Democrat, co-sponsored the original federal enterprise zone bill. Now, twelve years later, Congress finally appears ready to send a tax incentive bill to the White House. The current zone proposal in H.R. 11 is part of this year's evolving urban aid package, which was triggered by this spring's riots in Los Angeles.

Early in 1991 the Bush Administration introduced its own enterprise zone legislation (H.R. 23, S. 1032). Two months of negotiations between House Majority Leader Richard Gephardt, the Missouri Democrat, and White House officials, produced the current zone proposal contained in H.R. 11.

The tax package agreed to by House and Administration negotiators also would authorize $2.5 billion over five years for programs under the Administration's "Weed and Seed" initiative, a last-minute inclusion in H.R. 11. Funding for it would go almost exclusively to enterprise zones, with 80 percent allocated to urban zones for most activities. The "weed" portion of this program would fund police sweeps of known and suspected felons from high-crime areas. The "seed" portion, which constitutes most of the funding, would direct social services of mainly existing programs (such as Head Start and the Job Corps) to these areas. The program encourages the use of community policing as a bridge between residents and police.

While the House legislation is an important step toward creating enterprise zones in depressed cities and towns, it contains several flaws. The Senate should avoid these when it considers enterprise zone legislation. Specifically the Senate should:

✔ **Create more urban zones.** The House bill creates 50 zones, 25 each in urban and rural areas. But the enterprise zone approach is best suited to urban communities, and the need is more urgent there. The Administration proposal of putting two-thirds of the zones in cities would be more appropriate.

✔ **Exempt all capital gains from taxation, and include the Administration's proposal for two years as the minimum holding period.** The House bill would defer capital gains tax liability on tangible (buildings and equipment) assets and certain intangible (corporate stock, interest in a partnership) assets until the proceeds from sale of a business interest are taken out of a zone. If an entrepreneur owns all or part of a business for at least five years, only 50 percent rather than all of the proceeds would be taxable. Example: An owner or part-owner of a business in an enterprise zone sells off an interest he has held for a decade. Part of the sale reflects a $200,000 gain in the value of qualified capital assets. Thus, $100,000 of the proceeds would be subject to capital gains taxation.

The Administration bill had called for a full exemption from taxation on capital gains, whether or not reinvested in a zone, with only a two-year minimum holding period. This would be a much stronger incentive, and a necessary one if investors are to risk their money in very depressed neighborhoods. The House bill in some measure reflects the false notion that cutting taxes on capital gains is a business giveaway. Yet capital tax relief is essential to encourage investors to support small businesses during their precarious early years.

✓ **Allow investors to deduct up to $50,000 annually on the purchase of enterprise zone stock.** Under the House bill, investors could deduct up to $25,000 annually from taxable income for the purchase of qualified enterprise zone stock. They may deduct up to $250,000 over their lifetimes for this purpose. The Administration bill would have established an annual cap of $50,000. The House annual cap of $25,000 is too low to trigger significant investment in certain businesses. The Senate should consider a higher cap.

✓ **Avoid zone czars.** Local administrators, known informally as "zone czars," would allocate up to $30 million annually per zone in tax deductions on the purchase of enterprise zone stock. These bureaucrats would decide which firms would be deserving of deductions, and in what amount. Allowing local bureaucrats to allocate tax breaks for enterprise zone stock purchases would be a profound mistake. For one thing it assumes these officials—who so far have not been able to achieve an economic turnaround in the areas—are better able than would-be investors to pick the "winners" in a zone. For another, it invites favoritism and special-interest lobbying.

✓ **Provide a credit to employees, rather than firms.** Under the House bill, new employers in enterprise zones would receive an annual nonrefundable tax credit of 15 percent on the first $20,000 (or a credit of up to $3,000) of each qualified zone resident employee's wages over the fifteen-year life of the zone designation. The original Administration bill would have provided a refundable 5 percent credit for employees, not employers, on the first $10,500 in wages.

The tax credit in the House bill would give firms little incentive to hire low-income zone residents. This is because small businesses during their early years typically incur little or no tax liability anyway, and therefore a credit is of no real value to them. A credit for the employee, rather than the firm, on the other hand would increase the take-home pay of employed zone residents, and give them a competitive edge in the labor market.

✓ **Focus on crime prevention in the Weed and Seed programs.** A safe environment is essential for success in enterprise zones. Yet only about 20 percent of the funds in Weed and Seed are targeted toward crime prevention. The bulk goes for questionable domestic spending programs, such as Head Start and Community Development Block Grants.

Congress is close to passing federal enterprise zone legislation with tax incentives, after twelve years of dithering. Congress has come to understand tax breaks are needed to energize economically depressed areas. What lawmakers now need to remember is that enterprise zones will not work without a large dose of enterprise. That requires strong incentives to reward entrepreneurs. Too much of the House bill overlooks this requirement. It is now up to the Senate to send an enterprise zone bill to President Bush that will succeed in helping to rejuvenate deteriorating sections of America's inner cities.

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