HOW TO CREATE A SUCCESSFUL ENTERPRISE ZONE PROGRAM

After twelve years of deliberation, and pushed into long-overdue action by the recent riot in Los Angeles, Congress at last seems poised to enact enterprise zone legislation. What lawmakers now must do is remember the purpose of enterprise zones, take account of the long history of zones at the state level, and fashion a federal program that will work.

An enterprise zone is a depressed area in which taxes are reduced and regulations streamlined in order to encourage businesses to open and expand—thereby creating jobs and spurring an economic turnaround. Over the past decade, some 37 states and Washington, D.C., have enacted enterprise zone programs. These programs offer a mix of tax, financing, and deregulatory incentives to firms investing in areas designated as enterprise zones. According to the U.S. Department of Housing and Urban Development (HUD), state enterprise zones since 1982 have created some $28 billion worth of new business investment and over 258,000 jobs.

Prior to the riot, two major bills had languished in Congress. The first, backed by the Bush Administration, was introduced in the House (H.R.23) by Charles Rangel, the New York Democrat, and in the Senate (S.1032) by Democrats Joseph Lieberman of Connecticut and J. Bennett Johnston of Louisiana, and by Republicans John Danforth of Missouri and Robert Kasten of Wisconsin. This bill would create fifty enterprise zones (one-third in rural areas) over a four-year period. Each zone would be eligible for 25 years to receive three generous tax incentives to encourage business growth:

- ✓ **An exemption from taxation of capital gains on the sale of "tangible" enterprise zone property (that is, such things as buildings and machinery) held for at least two years;**
- ✓ **A personal income tax deduction for investors of up to $50,000 in any taxable year, with a $250,000 lifetime maximum, on the purchase of qualified enterprise zone common stock; and**
- ✓ **A refundable 5 percent tax credit to qualified enterprise zone employees on the first $10,500 in annual wages, up to $525 per worker.**

The U.S. Treasury Department has estimated that these incentives would cost almost $1.8 billion in lost federal tax revenues during the initial five years of operation. Supporters of the bill claim this is an overestimate, since the Treasury ignores new taxes that would be generated by zone businesses. HUD would designate areas as zones on a competitive basis from among areas meeting certain criteria of distress (such as high rates of poverty and unemployment).

A rival bill, H.R. 11, introduced by House Ways and Means Committee Chairman Dan Rostenkowski, the Illinois Democrat, also would provide tax incentives, but not as generous as those of the Rangel bill. More problematic, the Rostenkowski bill in many ways would add bureaucracy. Specifically, it would require local zone *administrators*, known informally as "zone czars," to allocate federal tax incentives to the firms they wanted in the zones. The zone czars would pick and choose among businesses—forcing entrepreneurs to lobby for tax breaks.

The Administration recently has developed several new enterprise zone incentives. They have yet to be inserted into H.R. 23, but likely soon will be.

Among these refinements:

- ✓ **Investors would pay no capital gains tax on the appreciation of "intangible" (such as stocks and bonds) as well as tangible property in an enterprise zone;**
- ✓ **Enterprise zone businesses could raise capital through tax-exempt state and local bonds;**
- ✓ **Unemployed, childless persons who obtained jobs in zones would receive an earned income tax credit (EITC) of up to $1,800 annually. Currently, the EITC applies only to families with children.**
- ✓ **Homeowners in enterprise zones would be exempt from capital gains taxation on up to $200,000 in profits from the sale of a home owned at least five years; and**
- ✓ **The federal government would grant automatic enterprise zone status to any locally designated zone that meets distress criteria.**

Treasury officials calculate the five-year revenue loss of this expanded proposal at $2.3 billion.

Some of these changes, such as the capital gains and expanded earned income tax credit provisions, are sound. These measures would encourage more investors to risk their money in depressed areas, and they would raise the take-home pay of lower-skilled workers hired by enterprise zone businesses. But others, such as granting enterprise zone status as an entitlement to any area meeting economic distress criteria, actually would weaken the program. Thus, in crafting a final bill, lawmakers should be careful to abide by four basic principles, underscored by the experience of state enterprise zone programs:

Principle #1: Enterprise zone designation should be competitive. The Administration's recent proposal to make federal enterprise zones into an urban entitlement program is a mistake. Enterprise zones are effective only if state and local governments remove obstacles to business growth, such as rigid zoning and onerous property taxes. A competition for designation would force states and cities to take necessary actions to secure a slot. But if the program is an entitlement, there would be no such incentive.

Principle #2: Government at all levels must resist the temptation to overregulate and "micromanage" economic activity within zones. Federal enterprise zone legislation should spur business creativity by reducing taxes and regulatory barriers for all entrepreneurs willing to take a risk—not just those who fit a bureaucrat's master plan. Micromanaging instead forces firms to lobby officials for benefits. And in such a tussle for influence, the smallest, newest firms would be least able to obtain relief.

Principle #3: Zone benefits should be kept simple. Some state zone programs grant numerous and complicated tax, financing, and deregulatory incentives. Qualifying for them entails a large amount of paperwork, which can be especially time-consuming for the small businesses which zones are intended to attract. Complicated requirements thus encourage "tax shopping" by large, existing firms, and discourage the creation of new firms.

Principle #4: The focus should be on small businesses. Small firms are the biggest generators of new jobs, especially for lower-skilled workers. Thus the zone program should be founded on incentives that are of most help to these firms. Capital gains tax relief is especially important, because it would increase the flow of start-up capital to businesses. State and local governments must clear away the red tape that is merely irritating to large firms, but often suffocating to small ones.

The time is at hand to create federal enterprise zone legislation that fulfills the promise of the original idea. It is true that reducing tax and regulatory burdens in designated geographic areas should not divert attention from reducing them everywhere. It is true also that an enterprise zone is but one element in the package needed to reduce the isolation of the urban poor. Education reform also is needed, as is action to tackle crime, to reform the welfare system, and to foster homeownership in poorer neighborhoods. But a transformation will not occur fully until businesses open and hire people in the inner cities. That is why a properly crafted enterprise zone program is essential.

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