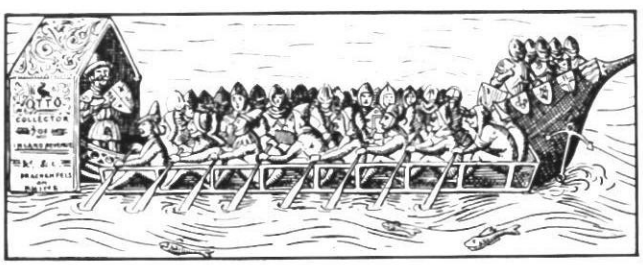
ENTERPRISE ZONES: THE TAX CODE AS AN URBAN DEVELOPMENT TOOL

by Carl William Struever

Over the last few years the Federal programs that played a key role in Baltimore's revitalization — the Urban Development Action Grant program, the Economic Development Administration, the Comprehensive Employment & Training Act and the Small Business Administration to name a few — pumped literally hundreds of millions of dollars of economic development assistance into the city. Today this array of Federal support, a victim of the Reagan Administration budget, is on the verge of collapse. EDA and UDAG are to be eliminated entirely; CETA and the SBA are to be reduced to a vestige of the previous effort.



Background On Enterprise Zones

Out of this radical retrenchment only one new initiative is a possible new Administration urban policy: enterprise zones. First presented in this country in 1980 by Stuart Butler of the conservative think-tank Heritage Foundation, the basic concept of enterprise zones is to "green line" distressed areas of our inner cities by providing a host of tax incentives and by reducing government regulation. This would create what Butler called "pioneering in the inner city:" the growth of small business, creation of jobs, and in particular the stimulation of entrepreneurship.

Introduced in Congress last year by the partnership of the ex-quarterback "supply sider" Republican from Buffalo, Jack Kemp, and the liberal Democrat from New York City, Robert Garcia, "The Urban Jobs and Enterprise Zones Act" is soon due for reintroduction. The '81 version that was introduced June 11 is substantially improved over the somewhat primitive original version. Kemp and Garcia deserve much of the credit for making a major effort to solicit advice on the enterprise zones concept from a wide range of local elected officials, urban development professionals, community organizations and business groups.

The new bill responds to many criticisms raised. A complaint voiced by the NAACP is "gentrification," the claim that middle-class home renovators of inner-city neighborhoods displace poor residents. The response was anti-speculation provisions and tax incentives for construction of low income rental housing. The National League of Cities raised the criticism that jobs won't go to those most in need; the response was that businesses would be required to hire 40 percent of their workers from those who are "CETA eligible" in order to receive tax breaks. The National Conference of Mayors objected that property tax reductions proposed were neither legally nor politically feasible; the response to this was to drop the property tax reduction feature and substitute a more flexible local commitment. Now cities could streamline zoning and building regulations, build streets and sidewalks or provide financing. Private organizations could offer technical assistance to new zone businesses. Funds for this local commitment could come from other Federal grant programs.

Carl William Struever *is president of Struever Bros. & Eccles Inc., a leading company in Baltimore, Maryland that specializes in custom residential and commercial renovation. As chairman of Baltimore's Economic Development Committee, he works closely on the city's unemployment and housing problems, and has been invited throughout the country to speak on Baltimore's revitalization program.*

Kemp and Garcia also propose to replace the reductions in social security taxes with refundable Targeted Jobs Tax Credits and employee tax credits. The eligibility criteria for zone designations are broadened to be comparable to UDAG "pockets of poverty" and to allow localities more responsibility in the setting of enterprise zones boundaries.

To help provide financing for zone businesses, 40 percent of interest income on zone business loans would be tax-exempt, similar to an automatic industrial revenue bond. The most important change, perhaps due to concerns voiced by urban interest groups such as NAACP, the League of Cities, the Conference of Mayors and others, is that the enterprise zones is not designed to replace existing jobs, housing, or urban development programs like CETA, UDAG, and EDA, but to be a complement to existing programs.

Even after all these changes, however, the primary strategy of the enterprise zones proposal remains consistent. The focus is on the creation of jobs as the most effective means of battling the social and economic ills of the city. It is expected that a person with a meaningful job that pays a decent wage will have the self-confidence and capability to take care of his own housing, medical care, or schooling problems.

For long-term economic stability, jobs should be created in the private not public sector. Citing recent studies like the Birch report from MIT, "Enterprise Zoners" say that incentives should be targeted to the particular needs of new and small businesses since they are the source of the greatest number of new jobs. The enterprise zones also seek to create the right environment for business and job growth purely through tax incentives, or as supply siders like to call it the elimination of tax disincentives, rather than the more traditional direct Federal subsidies such as job training, public improvements and financing.

The "Urban Jobs and Enterprise Zones Act" draws its strength and weakness from this focus on urban revitalization through the provision of tax breaks to generate private sector growth and the creation of jobs. The strong tax relief and business growth orientation gives the Act a tremendous basis of support both in Congress and the White House. Enterprise Zones is the only new urban revitalization initiative that older cities can hope for in today's political climate.

Unfortunately it is this same single-minded, simplistic orientation that does not bode well. This country has been active in the urban renewal business for more than three decades and we've learned that the city is a complex environment of interwoven cultures where physical scale affects social life-styles and vice versa. Urban problems interlock as well. A good education is essential to job training; a solid home environment is important for successful schooling.

The best and most successful development practitioners know that complex urban problems require comprehensive multifaceted solutions, not characteristics of the Enterprise Zones and Reagan urban policy.

Flaws Of The Concept

Few critics of the enterprise zones concept oppose its principal goals of stimulating business growth in distressed inner city areas and providing new jobs for needy people. Economic development and the creation of private sector jobs were the centerpiece of the Carter urban policy. Many liberals support the enterprise zones strategy of using the U.S. tax code as a weapon to fight urban decay.

Robert Embry, the past assistant secretary of HUD for community development and a chief architect of the Carter urban policy, can detail the efforts of the previous administration to end tax policies such as the Investment Tax Credit that encouraged business to abandon cities in favor of new plant development in suburban areas. The 10 percent Investment Tax Credit for renovation of commercial buildings which are at least 20 years old, and accelerated amortization provisions for rehabilitation of certified historic structures, made a first step toward encouraging reuse of deteriorated inner city buildings. Thus, "place specific" tax incentives as proposed by the Enterprise Zones Act would be a major step forward for urban redevelopment.

The great criticism of enterprise zones as the centerpiece of Reagan's urban policy is that the zones are not only the centerpiece, but practically the entire Reagan urban policy, with the exception of homesteading. Homesteading, where homeowners buy a vacant, deteriorated house for $1 in return for a commitment to renovate and live in the house themselves, became in 1974 one of the Federal "categorical" programs so disliked by the Republicans. Over 60 cities have experimented with varying success with homesteading. When Reagan announced during the first Presidential debate that homesteading was his remedy for urban blight, knowledgeable analysts were stunned by his apparent ignorance of the fact that homesteading was not a *new* concept and by the inadequacy of the program as a comprehensive solution to complex urban problems. Embry, who directed in Baltimore what is widely acclaimed as the most successful homesteading program in the country, calls the concept "nice" but limited and only a tiny component of an overall urban redevelopment policy.

Despite belated claims by the enterprise zones bill's sponsors Kemp and Garcia that the "Urban Jobs and Enterprise Zones Act" is a complement to existing programs, the intent is to present enterprise zones as the grand new solution. On a larger scale, just as Enterprise Zones is the new Reagan approach to city

problems, it also becomes the standard bearer for less government participation, less taxes, and a business-can-do-it-all attitude.

As a large-scale solution Enterprise Zones is criticized in two ways: 1) Tax incentives are mechanically the least effective means for the public sector to stimulate business growth and create jobs, in comparison to other public programs such as financing assistance, site preparation, and labor force training; 2) Enterprise Zones and tax incentives ignore the complex relationship between business growth and public sector support for the overall urban environment, from arts and culture to rodent control, transportation, and the school system.

Three Point Development Plan

Testifying before the Business Roundtable on Enterprise Zones, Bernie Berkowitz, president of the Baltimore Economic Development Corporation (Bedco), described the key elements of the public-private sector partnership in economic development, none of which are included in the Enterprise Zones Act. As president of Bedco, the city's principal industrial development agency, and formerly the economic development coordinator to Mayor Schaefer of Baltimore, Berkowitz could speak with authority about the public program he felt played a key role over the last 10 years in Baltimore's startling renaissance. The areas were:

1. *Site preparation* — Inner cities lack developable sites due to their congested, built-up condition. Federal funds from the Economic Development Administration often supported the acquisition, clearance, and consolidation of sites followed by the construction of the necessary public infrastructure to create an attractive environment for business investment. Help in obtaining necessary building and zoning permits, environmental clearances, and other government regulatory approvals can also play an important role.

2. *Financing* — A wide range of financing aids were offered for long-term capital improvements, equipment and fixtures for a business' physical plant, for short-term working capital and inventory financing to ease cash flow problems during the first few years of rapid growth, and for venture capital financing to provide the equity or "risk capital" to encourage banks to make the primary long- and short-term loans. For new and small businesses which are the target of Enterprise Zones incentives, the failure rate is so high that private financing is difficult to obtain. The Birch report estimates that four out of five small businesses fail in the first five years. Small business financing was difficult even when the prime rate was 7 percent. With interest rates at their recent levels, obtaining sufficient cash for a business start-up is extremely difficult.

As a result, both publicly supported direct loans and loan guarantees became a key element in economic revitalization. For example, loan guarantees from the SBA not only reduced the risk for the private lender but permitted longer-term amortization and reduced monthly debt service costs. Direct loans were at a lower rate of interest because the SBA took advantage of the Federal government's ability to obtain funds less expensively than private lenders and further reduce debt service. Urban Development Action Grants were structured as "gap" financing — making up the difference between the amount private lenders were willing to invest in a project and the actual cost.

In most development projects private financing still provided the majority of funds while public programs shouldered some of the risk, satisfied the fund shortfall, and reduced the effective cost of the overall financing package so that the project would be feasible for both the private lender and the business.

3. *Support services* — Even after providing a suitable site and financing to build and operate on, Berkowitz pointed out that other public programs were still essential to attracting new business and ensuring the continued viability and growth of that business after its door opened. First and foremost was labor force training.

A study conducted by Roger Schmenner of the Harvard-MIT Joint Center for Urban Studies surveyed 410 companies owning 18,000 manufacturing sites to determine the implications for public policy of location decisions of large firms. An astonishing 76 percent of the plants listed a favorable labor climate as a must in choosing a new plant location. A good supply of skilled workers becomes critical. Schmenner goes on to describe the successful use of customized preemployment skill training in attracting new business in the southeastern United States.

If the goal of enterprise zones is to provide jobs for the hardcore unemployed who lack marketable skills, on-the-job and skill training subsidies are essential. New and small businesses in particular cannot afford the high cost of providing training opportunities where new workers can often reduce production output. Not only do new, untrained workers have low outputs, but they also take up time from experienced, highly paid workers. Another recent study from Laura Morlock of Johns Hopkins University documents the successful record of the Comprehensive Employment and Training Act (CETA) in preparing the unskilled for private employment. Two years after the end of CETA program training, 78 percent of the trainees had permanent, unsubsidized jobs. After five years, only 6 percent were still looking for work which was less than the unemployment rate in the Baltimore area.

Technical assistance can also aid new and small business survival. Commercial Credit, with a Federal

grant from the Department of Commerce, is establishing Business Resource Centers that provide legal, accounting, marketing and management assistance to small businesses in a comprehensive setting.

Berkowitz goes on to explain how site preparation, financing, and job training can work together to stimulate business growth. At Fort Holabird, Baltimore used an Economic Development Administration grant to purchase land and a $9 million UDAG to pay for bridge and road improvements essential to a $220,000,000 proposed expansion of the General Motors plant that saved 5,000 jobs for the city. In a neighborhood commercial area in South Baltimore, a $900,000 EDA grant paid for heating and air conditioning for the local public market and the SBA and city combined loan programs to finance the renovation of deteriorated storefronts. In three years 50 new businesses opened and created hundreds of jobs and millions of dollars in increased tax base.

Park Circle in Northwest Baltimore, often cited as a prime enterprise zones candidate, is an industrial park project in a black community with a 20 percent unemployment rate that will use the whole range of development tools. Public funds will be necessary to acquire land and build the infrastructure. The city will back a tax exempt industrial revenue bond issue for the construction of a Control Data-operated Business & Technology Center. By providing shared low-cost legal, accounting, and service facilities, the center will become a breeding ground for new business. A direct city loan financed the first minority-owned business. CETA funds pay a private developer, City Ventures, Inc., to manage the project and provide the critical link between businesses and the hiring of unemployed residents in the neighborhood. CETA will also provide subsidies for on-the-job and skill training.

Tax Breaks As Incentives

The experienced City Ventures staff feels that tax breaks would be a good additional incentive to development. However, they and Berkowitz maintain that without the other public development tools tax incentives would be ineffective. First of all, new and small businesses don't need tax breaks because they don't make enough money to warrant paying taxes. They are concerned with finding the money to construct and equip their plant, to pay their payroll every Friday and pay suppliers at the end of the month. Secondly, tax breaks have a historical tendency to end up with big businesses anyway. According to Milt Stewart, editor of *Inc. Magazine*, small manufacturing firms with sales of less than $100,000 receive tax credits of only 5.8 percent of total tax liability, whereas billion dollar firms get credits amounting to a whopping 61.1 percent of tax liability.

Third, big business doesn't relocate much, to say nothing about moving into enterprise zones. Both Birch and Schmenner provide substantial evidence that plant migration is not a major factor in economic development.

Fourth, even for those established businesses that do move, tax incentives are not important in the decision making process. In his study of the location selection process, Schmenner lists labor force training, public infrastructure improvements, livability of the area, and other related factors as being the most important. According to Schmenner, tax incentives are ineffective. His study reported that less than a third of relocating plants moved to areas with lower tax rates. Only 14 percent of new plants took advantage of tax abatements as compared to 38 percent that required public infrastructure improvements. A 1980 report from North Dakota indicated that only seven of 125 new firms that received the state's five-year income and property tax exemption felt that the exemption contributed significantly to the decision on a plant location.

Fifth, tax incentives are not cost effective. Embry points to the UDAG program which has a "but for" provision that limits funding only to those projects that have substantial public benefits and would not go ahead "but for" the UDAG. Tax incentives as in the North Dakota example are not so efficient when the same tax breaks go to the 118 firms who would have located in the state anyway. Estimates on the slippage of the Investment Tax Credit range from 40 to 70 percent of the lost tax revenue going to firms that would have made the investment regardless of the tax incentive.

Sixth, tax incentives require expensive lawyers and accountants. Anyone who has been through an industrial revenue bond settlement, where the interest from the loan is tax free, or through a syndication of the accelerated depreciation write-offs of a low income housing project, is aware of the mountains of necessary legal agreements and opinions. The $30,000 average legal fee for an industrial revenue bond issue has made that type of financing prohibitively expensive for the small businesses targeted by enterprise zones. Japan has two lawyers and accountants and 76 scientists for every 10,000 people, while the United States has 200 lawyers and accountants and one scientist for the same number of people. Enterprise zones will help keep those 200 lawyers and accountants busy, but might not do much for the scientists.

Seventh, tax incentives are difficult to target on specific public benefits. For example, if the goal is to get jobs to needy people, a grant program like UDAG on a case-by-case basis can use some flexibility with individual developers to establish minimum hiring and job training goals suitable to a particular project. Such sharp targeting while retaining compliance flexibility is difficult to achieve within the context of the tax code. The poor response from businesses to the Targeted Jobs Tax Credit is a good indicator of

the limited potential for zeroing tax breaks in on a complex problem.

Such a condemnation of tax incentives as a development tool elicits a spirited defense from supply siders like Kemp and others who maintain that tax incentives don't cost the government anything because they are unleashing private sector growth that wouldn't pay taxes otherwise. Embry counters with a documentation of business growth generated by a grant program like UDAG that costs the government X dollars on a budget appropriation but pays back X+Y dollars in taxes. Any tax break given to one of these UDAG generated businesses is truly a tax expenditure.

The supply sider and Enterprise Zoner obsession with tax breaks rests on the need to try something new based on a belief that everything the Federal government had previously tried in urban redevelopment was unnecessary. David Smick, chief of staff for Jack Kemp, likes to ridicule public sector financing by waving a graph showing that 90 percent of all new businesses finance their ventures from personal or family savings and only 3 percent use SBA or other public loan or loan guarantee programs. Wherever that statistic came from, it is not applicable in an enterprise zones situation where there is a deteriorated physical plant requiring extensive renovation or new construction. High technology firms, often cited as prime zones candidates, are particularly capital intensive. Minority-owned businesses, which should be a zones target, rely heavily on public financing.

Criticism Of "Federal Bulldozer"

A more fundamental flaw of the enterprise zones concept is the underlying philosophy that all previous Federal urban redevelopment programs are failures. Both Butler and Kemp refer to the need for an alternative to the "Federal Bulldozer," that is, something new and different from the ravages of classic urban renewal where square miles of inner city neighborhoods were demolished for grand development plans that never materialized. Butler quotes Senator John Chafee (R-RI), a strong supporter of enterprise zones, as saying:

> "Since the great 'Urban Renewal' surge of the 1960s, all we have been doing is bulldozing great holes in our cities and throwing billions of Federal dollars down them. Little has resulted, little has changed. We need a bold new approach."

Unfortunately for Kemp, Butler and Chafee, however, the "Federal Bulldozer" died out as a Federal development strategy 20 years ago. In the early '60s the emphasis began to shift to neighborhood-based rehabilitation programs. Plans were thought out in cooperation with community organizations or Project Area Committees. Jane Jacobs, in *Death and Life of Great American Cities* and Herbert Gans, in *Urban Villagers*, helped us understand cities as complex environments. Simplistic solutions to urban problems, like urban renewal, led to disastrous consequences.

In 1968 Congress fashioned the ultimate response to complex, interlocking urban problems with the multifaceted Model Cities Program in which improvements of all aspects of neighborhood life became top priority.

The uncontrolled spending on the Vietnam War sabotaged Model Cities before it got under way. When Nixon froze housing program funds, he signaled a step away from Federal targeting of programs on specifically defined renewal areas. Incentive programs were offered on a citywide basis. Block grants allowing greater local government flexibility were emphasized. Broadbased Federal incentives sought to stimulate private sector growth, culminating in Carter's public-private sector partnership for the '80s and the UDAG program.

Since the "Federal Bulldozer," some programs have failed and others, such as UDAG, proved effective. With the revitalization of cities such as Baltimore, "The Renaissance City," we've learned that the key to success is a comprehensive, balanced development strategy. As Berkowitz pointed out, balanced business incentives — financing, site preparation, labor force training — must work together. Making the city an exciting place to live is a top priority. As Schmenner says in his business location study, liveability is an "awesome competitive advantage" in attracting new business. Support for arts and cultural institutions, entertainment, parks, historic and architectural preservation, all make a vibrant environment. A major league ball team or a top notch symphony may well be more effective than a 15 percent business tax reduction. A bright and vital shopping center like Fanueil Hall or Harborplace may bring a business person to Boston or Baltimore faster than a ten-year carry forward of losses. Public grant support is a crucial part of these activities.

Summary

Unfortunately, nothing in the "Urban Jobs and Enterprise Zones Act" or the entire Reagan economic program begins to recognize this complex relationship of social, cultural, and physical factors that make urban redevelopment work. By blindly ignoring our past history in urban revitalization, the Enterprise Zones Act is in danger of making the same blunder that planners made in the 1950s with the "Federal Bulldozer." A simple, business-can-do-it-all solution just will not work. In the name of cutting government waste, the Enterprise Zones as an urban policy will only create more waste.

As one component of a comprehensive urban policy, however, enterprise zones could be a valuable new

tool to stimulate private investment. Tax incentives, offered with a balance of other necessary public incentives such as financing and site preparation, can help attract desperately needed jobs to distressed communities.

Features such as the 40 percent tax exemption on interest income or loans to zone businesses are a bold and creative move to correct a critical capital shortage for growing businesses. An accelerated depreciation provision, currently not included in the legislation, would be an added attraction.

As Kemp's chief of staff points out, Enterprise Zones, even with all its problems, is the only urban initiative with a chance of survival in today's political environment. For all the shortcomings of the legislation, Kemp and Garcia should be applauded for their attempt to focus the new conservative economic strategy on the desperate problems of our inner cities.

The new Administration has demonstrated little interest in learning from our past experience in urban revitalization. With the President's giant step backward from our nation's commitment to help the underprivileged, any positive effort at all will help keep us from the social disintegration and chaos that threatens our society.