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Caution: Enterprise Zones

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ARTICLES

CAUTION: ENTERPRISE ZONES

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I. INTRODUCTION

In May 1992, President Bush reacted to the civil disturbances in Los Angeles by dusting off a Republican proposal to grant certain tax breaks to businesses located in designated areas known as enterprise zones. According to the President:

The enterprise zones—there is an idea whose time has come. . . . Change the tax structure so that this place can serve as a magnet to bring jobs with dignity into the private sector. That idea is . . . on the table right this minute in the Congress, and the Congress ought to pass it and pass it fast!¹

The tax incentives envisioned by President Bush focused on excluding from income capital gains from the sale of property in enterprise zones. While Congress did not ignore the President's plea, it changed the content of his enterprise zone legislation. In July 1992, the House of

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1. *Bush Plan to Aid Cities Stresses 'American Dream,'* L.A. TIMES, May 27, 1992, at A5 (quoting a campaign speech given by President Bush on May 21, 1992 in Cleveland, Ohio). After the disturbances, the President endorsed the concept of enterprise zones during a speech on May 8, 1992 at the Challenger Boys' and Girls' Club in South Central Los Angeles. Andrew Rosenthal, *After the Riots: Bush Pledges Help to Riot-Torn Area*, N.Y. TIMES, May 9, 1992, at A1. Federal enterprise zone legislation had first been introduced during the Reagan administration and became official administration policy as a form of supply-side economics. President Reagan included it in his 1982 State of the Union message. State of the Union Address, 18 WEEKLY COMP. PRES. DOC. 76 (Feb. 1, 1982). President Bush included an enterprise zone proposal in his fiscal 1993 budget request, OFFICE OF MANAGEMENT OF BUDGET, BUDGET OF THE UNITED STATES GOVERNMENT, FISCAL YEAR 1993 at 166-88 (1992). However, he vetoed a Democrat-backed tax package that included a more modest enterprise zone proposal. See H.R. DOC. No. 206, 102d Cong., 2d Sess. (1992).

Representatives passed H.R. 11, the Revenue Act of 1992.² Its tax breaks for enterprise zones included not only incentives for individuals to invest in businesses, but also for businesses to hire workers.³ The House bill, however, limited the number of urban enterprise zones to twenty-five.⁴ On September 29, 1992, the Senate passed its own version of H.R. 11,⁵ also including enterprise zone provisions.⁶ The Senate version eliminated all preferences for capital gains, expanded the wage credit, and increased the number of urban enterprise zones to seventy-five.⁷ The version recommended by the House-Senate conference committee and sent to the President as part of the Revenue Act of 1992 adopted the House language regarding enterprise zones.⁸ The President pocket-vetoed the bill.⁹

Nonetheless, given its bipartisan support,¹⁰ the concept of tax enterprise zones is likely to resurface. The purpose of this Article is to describe the recent enterprise zone proposals and the problems of relying

2. H.R. 11, 102d Cong., 2d Sess. (as passed by the House of Representatives on July 2, 1992), reprinted in 138 CONG. REC. H5864 (daily ed. July 2, 1992) [hereinafter H.R. 11]. This Article generally cites to the Congressional Record for legislative materials. Citing to the bill number gives no important information because the Article discusses different versions of the same bill.

3. Incentives for investment in business, including tools, machinery, equipment, and physical facilities, are known as capital incentives. Incentives to hire workers are known as labor incentives.

4. H.R. 11, *supra* note 2, reprinted in 138 CONG. REC. H5863 (daily ed. July 2, 1992).

5. Amendment to H.R. 11, 102d Cong. 2d Sess. (as passed by the Senate on Sept. 29, 1992), reprinted in 138 CONG. REC. S15,604 (daily ed. Sept. 29, 1992) (vote on final passage of H.R. 11) [hereinafter Amendment to H.R. 11].

6. *Id.* at S12,120-29 (daily ed. Aug. 11, 1992).

7. See *infra* text accompanying notes 104-08.

8. The conference report was submitted to the House at 138 CONG. REC. H12,227 (daily ed. Oct. 5, 1992). The enterprise zone provisions appear at 138 CONG. REC. H12,255-62 (daily ed. Oct. 5, 1992). The Joint Explanation Statement of the Committee of Conference, which explains that the House version was chosen, appears at 138 CONG. REC. H12,397-407 (daily ed. Oct. 5, 1992). The Conference Report was considered in the Senate at 138 CONG. REC. S16,926 (daily ed. Oct. 5, 1992). The Conference Report was agreed to in the House at 138 CONG. REC. H11,656 (daily ed. Oct. 5, 1992). It was agreed to in the Senate at 138 CONG. REC. S17,707 (daily ed. Oct. 8, 1992). The enrolled bill was signed in the House at 138 CONG. REC. H12,610 (daily ed. Oct. 29, 1992) and signed in the Senate at 138 CONG. REC. S18,262 (daily ed. Oct. 29, 1992).

9. In his memorandum of disapproval, President Bush explained, "I am withholding my approval of H.R. 11, the 'Revenue Act of 1992,' because it includes numerous tax increases, violates fiscal discipline, and would destroy jobs and undermine small business. The urban aid provisions that were once the centerpiece of the bill have been submerged by billions of dollars in giveaways to special interests." Memorandum of Disapproval, 28 WEEKLY COMP. PRES. DOC. 2283 (Nov. 9, 1992).

10. President Clinton supports enterprise zones. During his presidential campaign, he advocated creating "urban enterprise zones in stagnant inner cities, but only for companies willing to take responsibility. Business taxes and federal regulations will be minimized to provide incentives to set up shop. In return, companies will have to make jobs for local residents a top priority." BILL CLINTON & AL GORE, PUTTING PEOPLE FIRST: HOW WE CAN ALL CHANGE AMERICA 11-12 (1992).

exclusively on tax incentives. The Article will first discuss the assumptions behind and the goals of enterprise zones. It will then examine the limitations of tax enterprise zones, based on international, federal, and state experience with similar programs. Finally, it will consider why, if the decision nonetheless is made to adopt such enterprise zones, legislation should include incentives to hire workers.

The goal of this Article is modest. It does not attempt to offer an alternative to tax enterprise zones. Its purpose is to forestall complacency. We should not be confident that a tax enterprise zone program will by itself revitalize our inner cities, or even that tax enterprise zones are the best way to start.

II. PREMISES OF ENTERPRISE ZONES

Supporters of enterprise zones reason that, since the problems of our inner cities are geographically based, so should be the solutions. Some proponents of the enterprise zone concept believe that the problems of our inner cities represent a failure that the market alone cannot correct.¹¹ The deterioration of our inner-city neighborhoods produces a so-called "negative externality" that, like deteriorating air quality, affects us all. The problems of the inner city impose a cost on our society. Revitalizing neighborhoods will produce a positive externality, a public good that will benefit all. Neighborhood health is not something for which local businesses or residents, whose burden it is to produce, can charge. Thus, it is appropriate for government to act and to compensate such individuals and businesses for the costs they incur in producing this public good.¹² Others support enterprise zones out of a belief that reducing taxes and regulation will move these distressed areas closer to the ideal free market with its accompanying benefits.¹³

Both Congress and President Bush accepted the premise that tax breaks will compensate businesses and individuals for producing neighborhood health and will help to ensure that they produce it in sufficient quantity. This conclusion does not necessarily follow from either the

11. See JOINT COMM. ON TAXATION, 102D CONG., 2D SESS., PROPOSAL AND ISSUES RELATING TO TAX INCENTIVES FOR ENTERPRISE ZONES (Comm. Print 1992); David M. Maloney, *A Critical Analysis of the 'Enterprise Zone' Concept and its Application*, 34 TAX NOTES 261 (1987).

12. For a general discussion of externalities and public goods, see EDWIN MANSFIELD, MICRO-ECONOMICS: THEORY AND APPLICATION 497-500 (6th ed. 1988). Along with the quality of the environment, a classic example of a public good is national security. These goods do not flow to particular citizens, and even those who do not pay for them can enjoy them.

13. See Jack Kemp, *Testimony Before Finance Committee on Enterprise Zones*, 92 TAX NOTES TODAY 116-95 (1992), available in LEXIS, Fedtax Library, TNT File.

premise that urban health is a public good or the premise that the free market has been damaged. If our imperfect market does not provide sufficient affordable capital or insurance to inner-city businesses, for example, these businesses might benefit more from programs that provide loans or insurance than from programs, such as enterprise zones, that provide only tax breaks.

Proponents, however, assert that the tax incentives of enterprise zones will ameliorate many of the problems that gave rise to the civil disturbance in Los Angeles. Supporters make grand claims for tax enterprise zones: They will reduce alienation and despair; they will produce a sense of empowerment and commitment; they will give residents a stake in their communities.¹⁴ According to these proponents of enterprise zones, tax breaks will bring businesses to the inner cities, produce jobs, revitalize neighborhoods, and create stability.¹⁵ The Bush administration's proposal stated that the purpose of enterprise zones is:

to stimulate the creation of new jobs in the enterprise zones, particularly for disadvantaged workers and long-term unemployed individuals, to enhance the availability and delivery of local goods and services to residents and businesses in the enterprise zones, and to promote revitalization of the enterprise zones through meaningful entrepreneurial activity.¹⁶

According to both the House and Senate bills, the purpose of enterprise zones is "to revitalize economically and physically distressed areas, primarily by encouraging the formation of new businesses and the retention and expansion of existing businesses" and "to promote meaningful employment for tax enterprise zone residents."¹⁷

Clearly, residents of our inner cities need jobs. In his opening remarks at the Senate Finance Committee's June 1992 hearings on enterprise zones, Senator Lloyd Bentsen noted that unemployment was thirteen percent in South Central Los Angeles last year and fifty percent in some of its pockets.¹⁸ Residents of our inner cities would benefit from

14. See JOINT COMM. ON TAXATION, *supra* note 11, at 35-36; STUART BUTLER, ENTERPRISE ZONES: GREENLINING THE INNER CITIES (1981); Maloney, *supra* note 11, at 270-71.

15. JOINT COMM. ON TAXATION, *supra* note 11, at 35-36; BUTLER, *supra* note 14; Maloney, *supra* note 11, at 270-71.

16. 138 CONG. REC. S8560 (daily ed. June 19, 1992).

17. H.R. 11, *supra* note 2, at H5867; Amendment to H.R. 11, *supra* note 5, reprinted in 138 CONG. REC. S12,123 (daily ed. Aug. 11, 1992).

18. Bentsen's Statement at Finance Committee Hearing on Enterprise Zones, 92 TAX NOTES TODAY 116-15 (1992), available in LEXIS, Fedtax Library, TNT File. Sar A. Levitan and Elizabeth Miller observe, "in mid-1990, when national unemployment dropped to the lowest level in 16 years, about one-sixth of the metropolitan areas experienced recession level unemployment of seven percent

community-based small businesses. According to a widely cited study, small businesses represent our most important source of new jobs. This study, which surveyed eighty percent of the firms in the United States, concluded that firms with fewer than twenty employees created about two-thirds of all net new jobs, while very large firms tended to cause the loss of more jobs than they created.¹⁹ According to this study, the "only source of net new jobs in older areas is in smaller businesses, and . . . most of the jobs are in the trade and service sector, rather than manufacturing."²⁰ Thus, small businesses help residents of our inner cities to be employees.

Small businesses may offer other benefits as well. They serve the needs of those in the inner city as residents and consumers. Small, locally-owned businesses nourish a sense of community, pride, and commitment.²¹ Small businesses "tend to be more innovative and adaptive, producing the goods and services that are needed locally by the community."²²

As discussed below, however, tax incentives can begin to accomplish even the most modest of the goals claimed for enterprise zones only if they include incentives to hire workers.²³ Even if enterprise zone legislation emphasizes incentives for employment, experience with enterprise zones both in this country and elsewhere teaches us that we must proceed with skepticism and caution. We cannot expect too much from enterprise zones. Our inner cities and their residents face deep-seated

or higher." SAR A. LEVITAN & ELIZABETH MILLER, *ENTERPRISE ZONES: A PROMISE BASED ON RHETORIC* 2 (1992).

19. See DAVID L. BIRCH, *JOB CREATION IN CITIES* 36 (1980); DAVID L. BIRCH, *THE JOB GENERATION PROCESS* (1979); see also Robert Reich, *The Executive's New Clothes*, *NEW REPUBLIC*, Mar. 13, 1985, at 23, 23 ("Since 1970, America's 500 largest industrial corporations together have failed to generate a single new job."). Some studies, including quite recent ones, have questioned whether small businesses do in fact generate most of our new jobs. E.g. CHARLES BROWN ET AL., *EMPLOYERS LARGE AND SMALL* 2 (1990); Catherine Armington & Marjorie Odle, *Small Business—How Many Jobs?*, *BROOKINGS REV.*, Winter 1982, at 1, 14-17. In practice, enterprise zones seem to involve smaller businesses. Most firms attracted to British enterprise zones were small; 88% had 50 employees or less. Peter Hall, *The British Enterprise Zones*, in *ENTERPRISE ZONES: NEW DIRECTIONS IN ECONOMIC DEVELOPMENT* 179, 187 (Roy E. Green ed., 1991) [hereinafter *NEW DIRECTIONS*]. Similarly, a federal report on the enterprise zone established on Canada's Cape Breton Island found that small businesses were most successful at creating new jobs, even though 88% of the program's money went into businesses worth more than \$1 million. John Spears, *Cape Breton Ventures Big Drain on Taxpayers*, *TORONTO STAR*, Mar. 20, 1992, at C5.

20. BIRCH, *supra* note 19, at 36.

21. See JANE JACOBS, *THE DEATH AND LIFE OF GREAT AMERICAN CITIES* (1961).

22. Maloney, *supra* note 11, at 265.

23. See *infra* part IV.

problems. The problems relate to education, health care, crime, transportation, and a deteriorating infrastructure. Enterprise zones can do little to address these problems. The role for tax incentives in addressing the problems of our inner cities should therefore be a limited one. They should not serve as the centerpiece of urban policy in general or urban economic policy in particular.

III. THE CHOICE OF TAX INCENTIVES

Evidence from international and state enterprise zones as well as past experience with other federal tax incentives suggest that enterprise zones address the problems of inner cities too indirectly to produce benefits commensurate with their costs. Tax incentives, which are targeted tax breaks designed to induce particular behavior, reduce federal tax revenues. Such forgone revenues represent a cost to the federal government, much as direct grants or subsidies represent a cost. In the case of tax incentives, as in the case of government subsidies, we must evaluate the government program by asking whether the benefit is worth the cost. Policymakers need to evaluate enterprise zones by viewing the revenue lost from the tax incentives as a transfer of funds from the federal government to businesses.

Compared with the benefits they produce, tax incentives can be very expensive. Moreover, the cost of tax incentives, unlike that of direct subsidies, cannot be easily controlled. In contrast to subsidy programs, tax incentives seldom have ceilings.²⁴ Anyone who satisfies the requirements for the tax incentive may reap the benefits. The more who do so, the greater the revenue loss to the government. Even those taxpayers who would have undertaken or continued the desired behavior without the tax incentive will claim the benefit of the incentive. In other words, tax incentives such as those in the enterprise zone legislation may pay for nothing. For example, businesses already located in enterprise zones will be entitled to claim the benefits of the tax incentives, even if they would have operated in the zone without any tax benefits. Such has been the case with British and state enterprise zones.²⁵

24. See STANLEY S. SURREY & PAUL R. MCDANIEL, TAX EXPENDITURES 102-03 (1985) (tax expenditures are open-ended).

25. Studies of British enterprise zones indicate that 28% of the businesses were previously on site. Hall, *supra* note 19, at 187. Similarly, as discussed further, *infra* note 36, a study of four state enterprise zones revealed that the majority of firms receiving benefits were already in the zone. Richard C. Elling & Ann Workman Sheldon, *Determinants of Enterprise Zone Success: A Four State Perspective*, in NEW DIRECTIONS, *supra* note 19, at 136, 142-43.

Tax incentives may in fact induce changes in behavior, but produce tax revenue losses greatly exceeding the value of the activity induced. Experience with one federal enterprise zone vividly demonstrates this point. Since 1976, the Internal Revenue Code has included a federal enterprise zone with an income tax incentive: Under § 936 businesses may claim a tax credit equal to the federal tax liability on certain income earned in Puerto Rico and other U.S. possessions.²⁶ In effect, the credit exempts the income earned by qualifying corporations in Puerto Rico from federal taxation.

At the time it enacted the provision, Congress stated that its purpose was to help Puerto Ricans find jobs.²⁷ A May 1992 General Accounting Office ("GAO") report documents how poorly the provision has achieved this goal.²⁸ Using conservative estimates of tax benefits, the report found that the pharmaceutical industry received half the total tax benefit from § 936, but provided only fifteen to eighteen percent of the jobs of all § 936 corporations.²⁹ On average in 1987, for each dollar of employee compensation, these pharmaceutical companies received \$2.67 in tax benefits.³⁰ Of seventeen pharmaceutical corporations, two companies had tax savings per employee greater than \$100,000; seven companies had tax savings per employee between \$50,000 and \$100,000; and the rest had tax savings per employee less than \$50,000.³¹ During the 1980s, moreover, unemployment remained above ten percent in Puerto Rico.³²

The § 936 credit, a geographically based tax incentive, influenced the behavior of large and profitable corporations. In response to the credit, many pharmaceutical companies began operations in Puerto Rico.³³ There they could earn large amounts of income, generated by the intangible asset of the drug formula, free of tax. As the GAO study of

26. I.R.C. § 936 (1988).

27. See S. REP. NO. 938, 94th Cong., 2d Sess. 279 (1976) (adopting the credit of § 936 in order to "assist the U.S. possession in obtaining employment-producing investment by U.S. corporations").

28. GENERAL ACCOUNTING OFFICE, PHARMACEUTICAL INDUSTRY TAX BENEFIT OF OPERATING IN PUERTO RICO (1992) [hereinafter GAO], *reprinted in* 138 CONG. REC. S6634-42 (daily ed. May 14, 1992).

29. *Id.* at S6635.

30. *Id.* at S6637.

31. *Id.* at S6635.

32. *Id.*

33. *Id.* at 6639.

the Puerto Rican credit demonstrates, however, such an income tax credit generates jobs only indirectly and inefficiently.³⁴

The Puerto Rico experience highlights another potential problem of federal enterprise zones: Even if the tax incentives lure jobs to a designated zone, be it Puerto Rico or an inner-city neighborhood, the program will not be an efficient use of government resources if it relocates current jobs but does not create new ones. The image of "runaway" plants—businesses that have moved in order to take advantage of the Puerto Rico credit—has dogged the program. In 1991, for example, the Oil, Chemical, and Atomic Workers Union reported that more than 7000 jobs had been shifted to Puerto Rico since 1985, and Representative Stark introduced a bill to eliminate the § 936 credit for companies whose relocation to Puerto Rico would have a substantial adverse effect on mainland U.S. facilities.³⁵

If enterprise zones such as Puerto Rico's cause existing jobs to relocate instead of creating new jobs, one worker's gain will be another's loss.³⁶ If the jobs relocated to inner-city enterprise zones come from areas of low unemployment, the public good is likely to increase. If, however, the effect of enterprise zones is to shift urban blight from one neighborhood to another, enterprise zones will not be a good investment of resources. We must be particularly concerned about the effect of enterprise zones on immediately surrounding areas, the neighborhoods just outside the zone's boundaries.³⁷

Problems of job relocation will be far more complicated in domestic zones than in Puerto Rico. Because Puerto Rico is an island, the workers who benefit from the tax incentive will also be its residents. Such may not be the case with domestic enterprise zones. If a tax provision

34. Canada also found its enterprise zone to be costly. To attract investment to Cape Breton Island, an area of high unemployment, Canada offered a very large investment tax credit of 60%. The program, however, generated only \$75 of investment for every \$100 of government revenue cost. D. Holland, *Corporate Tax Incentives: Lessons from the Canadian Experience*, in *THE ROLE OF TAX REFORM IN CENTRAL AND EASTERN EUROPEAN ECONOMIES* 135, 142 (Organisations for Economic Co-operation and Development ed. 1991).

35. Karen Koff, *Stark Bill Would Deny 'Runaway Plants' Tax Credit*, 51 *TAX NOTES* 1351 (1991).

36. British enterprise zones have been found to experience a 37% increase in relocations. Hall, *supra* note 19, at 187. A four-state study of enterprise zones found that a majority of firms receiving tax benefits already operated in the zones, instead of starting up or relocating in those areas after their designation. Elling & Sheldon, *supra* note 25, at 142-43. Thus, these state enterprise zones spent state revenue for behavior that would have occurred without the expense.

37. See Maloney, *supra* note 11, at 276 ("It has been suggested that the companies outside the zone are subject to unfair competition from businesses inside the zone, that property values outside the zones allegedly fall relative to those inside the zone.").

requires only that the jobs be in the zones, workers who live outside the zones may well be the beneficiaries.³⁸ Requiring that enterprise zone businesses hire those who also live in the zones is possible, of course, but such a requirement would lead to administrative complexity and require considerable oversight.

Administrative oversight is troubling because one frequently mentioned advantage of tax incentives over governmental subsidies is precisely the relative freedom from administrative oversight and the burdens of bureaucracy.³⁹ Tax incentives, unlike government grants, are self-executing. Taxpayers decide their own eligibility. Self-selection simplifies administration and may have an important psychological effect. The geographical targeting integral to the concept of enterprise zones, however, is likely to undermine this advantage. If but a few zones must be chosen from the many eligible neighborhoods, someone must make the choice. The introduction of an enterprise zone "czar" to make these choices brings the problems and complications of bureaucracy and politics. If we limit the number of zones, we must anticipate battles over designating the zones, battles that will dissipate funds and undermine the program. If we do not limit the number of zones, their cost will increase as their effectiveness decreases. If, because of political pressures, a great many zones are created, they will not be sufficiently differentiated from surrounding areas and will lose the benefit of special treatment.

Moreover, the very premise of geographical entitlement introduces a variety of potentially serious problems. Businesses may locate in an enterprise zone only because the tax breaks make the businesses profitable. If the tax breaks end or are phased out, businesses which have become dependent on the tax breaks will fail, and the neighborhoods will suffer. In addition, geographical entitlements limit the mobility of employees as well as businesses. If the enterprise zone legislation provides a wage credit for employers, but requires that employees live in the zone in order for their employer to take the wage credit, it discourages residents from moving out of the zone. These residents may not take a job located outside the zone that would offer better pay or opportunity for advancement. The zone residents who need jobs do not necessarily

38. See DENNIS ZIMMERMAN, *FEDERAL TAX INCENTIVES FOR ENTERPRISE ZONES: ANALYSIS OF ECONOMIC EFFECTS AND RATIONALES*, 14 (Congressional Research Serv. Report No. 92-4765, 1989).

39. See SURREY & MCDANIEL, *supra* note 24, at 100-02.

need to work within the zone if they have access to jobs in other locations.⁴⁰

The Bush administration, House, and Senate bills resolved the issue of zone designation in different ways. The Bush administration bill imposed no limit on the number of enterprise zones. All distressed areas meeting criteria involving pervasive poverty, high unemployment, and high numbers of people on welfare would have qualified as enterprise zones.⁴¹ The Bush administration bill thus avoided the complications of selecting zones.⁴² The House bill, in contrast, authorized fifty enterprise zones between 1992 and 1997, of which only twenty-five would be urban enterprise zones chosen by the Secretary of Housing and Urban Development.⁴³ It limited the revenue effect of enterprise zones by accepting the discretion of a zone "czar."⁴⁴ The Senate bill also gave the Secretary of Housing and Urban Development authority to designate urban enterprise zones.⁴⁵ The number of zones, however, increased fivefold before the Senate voted on the bill and more than doubled the number proposed

40. Enterprise zones are the mirror image of tariffs. Tariffs increase the costs of operating within a zone. Enterprise zones decrease costs. Both attempt to protect business and workers within a zone. The arguments in favor of free trade apply to enterprise zones as well. It is ironic that the Bush Administration was arguing for a North American free trade bill at the same time it was pushing enterprise zones. Just as retraining workers for new jobs is more efficient in the long run than maintaining tariffs to protect jobs, so may increasing the skills of inner-city residents be better than providing tax incentives for employers to provide them with low wage jobs. See generally JAGDISH BHAGWATI, *PROTECTIONISM* (1988).

41. The Bush administration bill required that the area have a population of at least 3000. Such areas would have been nominated by a state or local government and designated by the Secretary of Housing and Urban Development. State and local governments would have had to agree in writing to follow a course of action to reduce the burdens borne by employers and employees in the area. Amendment in the nature of a substitute to H.R. 5260, 102d Cong., 2d Sess. § 311 (Bush administration enterprise zone bill), reprinted in 138 CONG. REC. S8561 (daily ed. June 19, 1992) [hereinafter Dole Amendment].

42. The Bush administration projected 150-300 zones under its bill at a cost of \$2.5 billion. Bennett Minton, *Administration Nears Draft of Enterprise Zone Bill, House to Move Ahead*, 55 TAX NOTES 1587 (1992).

43. H.R. 11, *supra* note 2, reprinted in 138 CONG. REC. H5868 (daily ed. July 2, 1992) (to have been codified at § 1391). For urban zones, the areas were small; they could not have exceeded 20 square miles. Minimum population would have been 1000. *Id.* at H5868-69 (to have been codified at § 1392). The Secretary would have chosen among nominated areas based on state and local contributions, private commitments, and revitalization potential. The bill also authorized 25 rural zones to have been chosen by the Secretary of Agriculture. *Id.*

44. The estimated revenue cost for both the urban and rural zones in the House bill was \$2.5 billion. Bennett Minton, *Senate Returns to Tax Bill as Election Deadline Looms*, 56 TAX NOTES 1239 (1992). The cost for these 50 enterprise zones was the same as the estimated 150-300 zones under the Bush administration bill because the House bill included more tax breaks than did the Administration bill. See *infra* text accompanying notes 99-103.

45. Amendment to H.R. 11, *supra* note 5, reprinted in 138 CONG. REC. S12,123-24 (daily ed. Aug. 11, 1992) (to have been codified at § 1392).

by the House. Senator Bentsen had originally proposed only twenty-five zones.⁴⁶ By August 11, the number had increased to 125, seventy-five of which would be urban zones;⁴⁷ the Senate bill adopted this number.⁴⁸ Along with this increase in the total number of zones, the estimated cost of the zones rose from \$2.5 billion to \$5.5 billion.⁴⁹

Enterprise zones that combine tax incentives with a zone czar with the power to direct tax benefits to a chosen few compound the disadvantages of tax incentives with those of direct subsidies. In any case, however, the enterprise zone legislation is primarily a program of tax incentives, and we must be most concerned with the problems inherent in tax incentives. Some tax incentives have proven cost-effective. For example, studies of the deduction for charitable contributions, which many classify as a tax incentive, find that the amount of contributions exceeds the lost federal revenue.⁵⁰ Other tax incentives, however, have imposed considerable burdens on the American economy. The tax shelters of the 1980s, for example, resulted from tax incentives gone awry.⁵¹ Enterprise zones, like those tax shelters, may end up giving tax benefits to investors without producing a commensurate benefit for American society.

The evidence from state enterprise zones further suggests that an emphasis on tax incentives is unlikely to benefit inner cities in any meaningful way. Thirty-seven states and the District of Columbia have some

46. *Id.* at S12,123. At a briefing for reporters held on July 24, Senator Lloyd Bentsen, Chairman of the Senate Finance Committee, noted his concern that enterprise zones might not work and that he wanted to concentrate expenditures where problems are most acute: "I hope we would not see this as patronage to be spread sea to shining sea, but keep it in limited areas." *Bentsen to Propose Tax Mark Featuring Restricted Enterprise Zone Initiatives*, 92 TAX NOTES TODAY 152-H (1992) [hereinafter *Bentsen*], available in LEXIS, Nexis Library, TNT File.

47. Amendment to H.R. 11, *supra* note 5, reprinted in 138 CONG. REC. S12,242 (daily ed. Aug. 11, 1992). Senator Mitchell announced the modification to the reported committee amendment to H.R. 11 on behalf of Senator Bentsen and the Finance Committee. *Id.* One commentator has explained, "In the face of pressure from senators and exercised mayors, Bentsen expanded the number of authorized zones to 125 and the cost from \$2.5 billion to \$5.5 billion." Minton, *supra* note 44, at 1249. Twenty-five of the seventy-five zones would have been urban zones. Amendment to H.R. 11, *supra* note 5, reprinted in 138 CONG. REC. S12,242.

48. Amendment to H.R. 11, *supra* note 5, reprinted in 138 CONG. REC., at S12,242 (daily ed. Aug. 11, 1992).

49. Minton, *supra* note 44, at 1239.

50. See CHARLES T. CLOTFELTER, *FEDERAL TAX POLICY AND CHARITABLE GIVING* (1985); Gerald E. Auten et al., *The Effects of Tax Reform on Charitable Contributions*, 45 NAT'L TAX J. 267 (1992); Don Fullerton & Shira D. Goodman, *The Economic Recovery Tax Act of 1981: Implications for Charitable Giving*, 16 TAX NOTES 1027 (1982), and studies cited therein. In 1980, for example, there were \$39.93 billion in donations, as compared to a revenue cost of \$8.31 billion. *Id.*

51. See STAFF OF JOINT COMM. ON TAXATION, 100TH CONG., 1ST SESS., *GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986* at 209-14 (Comm. Print 1987).

form of enterprise zone.⁵² These state enterprise zones differ considerably from each other in the incentives they offer and in how they operate. However, despite their differences, state zones share at least one trait: They do not rely primarily on income tax incentives. In part because state income taxes are usually low, state enterprise zones frequently offer property and sales tax incentives.⁵³ Moreover, states offer a variety of incentives other than tax breaks, like job training and low-interest financing.⁵⁴

Studies of state programs cast doubt on the ability of federal enterprise zone programs to achieve their goals.⁵⁵ For example, an evaluation of Maryland enterprise zones conducted by the General Accounting Office between 1986 and 1988 found no evidence that the program produced growth in employment.⁵⁶ The Maryland program consisted of employment tax credits, property tax credits, loan guarantees for long-term financing, increased loan limits for government land acquisition, and increased state redevelopment funds.⁵⁷ Survey data found that tax breaks and financing programs ranked near the bottom of the list of factors influencing location decisions.⁵⁸ The Maryland respondents chose market access as the most important factor. Site characteristics, government cooperation, community characteristics, and transportation also ranked high.⁵⁹ Similarly, a four-state comparative analysis concluded that administrative efforts and nonfinancial assistance are more important than tax and regulatory components to a zone's success.⁶⁰ The authors of the Maryland study concluded that "reliance on tax incentives

52. Enid Beaumont, *Enterprise Zones and Federalism*, in *NEW DIRECTIONS*, *supra* note 19, at 41, 41.

53. See *NEW DIRECTIONS*, *supra* note 19, at 89 (a section of the book is devoted to state enterprise zones); Maloney, *supra* note 11.

54. See *NEW DIRECTIONS*, *supra* note 19, at 89; Maloney, *supra* note 11.

55. Some, however, have argued that because state incentives are small, studies of state enterprise zones are not useful for designing federal programs. See *JOINT COMM. ON TAXATION*, *supra* note 11, at 36-37.

56. Patrick G. Grasso & Scott B. Crosse, *Enterprise Zones: Maryland Case Study*, in *NEW DIRECTIONS*, *supra* note 19, at 122, 133.

57. *Id.* at 123.

58. *Id.* at 132-33.

59. *Id.* at 133.

60. Elling & Sheldon, *supra* note 25, at 136. Studies of business location decisions not limited to enterprise zones have also found that tax incentives are not the most important factor cited for business location decisions. See Grasso & Crosse, *supra* note 56, at 133 n.6. Although enterprise zones began as an application of shameless free enterprise, see *infra* note 68, studies of state enterprise zones have found them to be more successful the greater the government intervention and the greater the administrative resources devoted to operating the programs. See Elling & Sheldon, *supra* note 25, at 145.

alone for enterprise zones is unlikely to lead to very dramatic effects on employment within the zones."⁶¹

These studies of state enterprise zones found tax breaks to have little impact even when they lowered property taxes or sales taxes.⁶² Such incentives reduce current operating costs for businesses. Unlike income tax incentives, property and sales tax incentives do not require the business to be profitable to benefit from the tax subsidy. Unlike capital gains tax reductions, they lower costs currently and not in the future. Nonetheless, property and sales tax incentives had little effect.

Even a study that reported favorably on state enterprise zones did not support the kind of federal enterprise zones proposed following the Los Angeles disturbance. Looking at enterprise zones in all thirty-eight jurisdictions, the study concluded that state enterprise zones did foster economic growth.⁶³ An analysis of data from a subset of zones, however, led the researchers to conclude that states should locate enterprise zones in areas that have basic labor skills, public infrastructure, and transportation access because, in such areas, being designated as a zone produces "incentives and visibility" that provide "marginal but catalytic contributions."⁶⁴ They warned, however, "Alternative programs may be more appropriate in the most distressed areas."⁶⁵ Federal enterprise zones are intended precisely for the most distressed areas.

Thus, the evidence from the state experience with enterprise zones forces us to question tax breaks as the means to entice new businesses to locate in distressed areas. Such efforts will produce little good unless we also address other needs of the inner cities. Even then, according to the state evidence, enterprise zones may have only a small impact. Experience with federal tax incentives suggests that we will pay a high price for the small impact.

61. Grasso & Crosse, *supra* note 56, at 133.

62. In Illinois, Indiana, Kentucky, and Ohio, the states in the four-state study, reductions in local property taxes figures varied widely and importantly. Other incentives included below-market financing and venture capital. Elling & Sheldon, *supra* note 25, at 138.

63. Rodney Erickson & Susan Friedinan, *Comparative Dimensions of State Enterprise Zone Policies*, in *NEW DIRECTIONS*, *supra* note 19, at 155, 174-75.

64. *Id.* at 175.

65. *Id.*

IV. TAX INCENTIVES FOR INVESTORS VERSUS TAX INCENTIVES FOR WORKERS

Different tax incentives provide incentives for different kinds of behavior and thus differ in their effects.⁶⁶ For example, a credit for investment in tangible property will encourage businesses to invest in machines rather than to expand their labor force or to increase outlays for research and development. If, despite the risks involved, policymakers choose to go the route of enterprise zones, they need to choose tax incentives that best benefit inner-city neighborhoods and their residents.

Incentives for investment capital are ill-designed to create new jobs and new small businesses. Nor did the originators of the concept expect enterprise zones to achieve these ends. American proponents of enterprise zones borrowed the concept from Great Britain.⁶⁷ Great Britain, however, anticipated that enterprise zones would revitalize abandoned and unpopulated industrial areas, such as the London docks. The British concept aimed at developing industrial parks, not neighborhoods. Its primary goals did not include creating new jobs or fostering small business.⁶⁸ The British enterprise zone concept contained no labor incentives. "British enterprise zone firms, in fact, are given every incentive to employ machines rather than people."⁶⁹

As it has been adopted in America, the enterprise zone concept has undergone a sea change. American supporters envision that the zones will revitalize poor neighborhoods and create jobs for their residents.⁷⁰ Since the purpose of enterprise zone legislation in this country differs from that in Great Britain, we must tailor the incentives to the American

66. This is so at least in the short term and at least in part. See *infra* note 86 for a discussion of how tax preferences are capitalized and thus affect price.

67. See generally Stuart Butler, *The Conceptual Evolution of Enterprise Zones*, in *NEW DIRECTIONS*, *supra* note 19, at 27; BUTLER, *supra* note 14.

68. The British enterprise zone concept developed from the work of Peter Hall, a former chair of the British Fabian Society. Hall had conceived of enterprise zones as a last-ditch effort, born of desperation. He described the concept as a "rare kind of social scientific laboratory experiment, on a small scale" where "fairly shameless free enterprise" would reign. Hall, *supra* note 19, at 182. Hall based the concept on his observations of Hong Kong. He later admitted that he had failed to appreciate the huge scale and importance of subsidized public housing in Hong Kong. *Id.* at 181. Hall drew two conclusions from the British enterprise zone experience: First, there was a "huge gap between the grand sweep of the original concept and the reality of what was actually achieved," and, second, "the experiment in practice, produced relatively small numbers of really new jobs, and at appreciable—but perhaps not excessive cost." *Id.* at 188-89.

69. Butler, *supra* note 67, at 34. The British plan exempted businesses in the zone from capital gains and property taxes and granted them increased depreciation allowances, simplified approval for planning, and relief from paperwork requirements. BUTLER, *supra* note 14, at 105-07.

70. See Butler, *supra* note 67, at 33-34; Maloney, *supra* note 11, at 266-67.

goal. Neither a general income tax incentive nor an incentive for investment satisfies the need to create jobs in poor neighborhoods.

The GAO study of the § 936 credit has shown how few jobs a general income tax credit produces.⁷¹ Other federal agencies have also expressed concern about the efficacy of the § 936 general income tax credit in aiding labor. In 1984 the Treasury Department suggested replacing the § 936 credit with a wage tax credit as a more direct and cost-effective incentive to create jobs.⁷² In February 1992, the Congressional Budget Office reported that substituting a wage tax credit would raise \$2.2 billion between 1993 and 1997.⁷³

Similarly, a recent study by the Congressional Budget Office, prepared in connection with hearings on enterprise zone legislation, urged that zone tax incentives be tied to the primary purpose of creating jobs.⁷⁴ The study concluded that capital subsidies are likely to have a very small effect on jobs and employment. It explained, "a capital subsidy will encourage capital intensive firms to locate to the enterprise zones and encourage all firms, including those already in the zone, to use relatively less labor and more capital."⁷⁵ Although subsidies for capital may increase labor output by encouraging output in general, in some cases "a capital subsidy will actually decrease employment and wages, making the residents of the zone worse off than they were before."⁷⁶ The report found that a labor subsidy would be more effective in increasing jobs and wages.⁷⁷

71. See *supra* note 28.

72. 2 U.S. DEPT. OF TREASURY, TAX REFORM FOR FAIRNESS, SIMPLICITY AND GROWTH 329 (1984).

73. CONGRESSIONAL BUDGET OFFICE, REDUCING THE DEFICIT: SPENDING AND REVENUE OPTIONS 329-30 (1992). The report also noted that, "despite complex limits, the primary incentive of the credit is to reallocate artificially the income from intangible assets developed in the United States to possessions rather than to encourage investment in tangible capital, such as plant and equipment." *Id.* at 329.

74. JANE G. GRAVELLE, ENTERPRISE ZONES: THE DESIGN OF TAX SUBSIDIES (Cong. Res. Serv. Report No. 92-4765, 1992).

75. *Id.* at 5 (basing her conclusions on econometric analysis).

76. *Id.*

77. *Id.* at 9. Incentives for labor, of course, are not without problems. When it is the employer who must claim the credit, there is a risk that employers will perceive eligibility for the credit as a stigma. See DEPTS. OF LABOR & TREASURY, USE OF TAX SUBSIDIES FOR EMPLOYMENT: A REPORT TO CONGRESS, H.R. DOC. 4055, 99th Cong., 2d Sess. (1986). Moreover, labor-intensive industries will benefit particularly from such a credit. Labor-intensive businesses pay low wages and do little to improve skills or offer advancement for their employees. A credit for wages may benefit minimum wage workers more than other workers since employers who would not hire workers at the minimum wage may do so if the credit reduces their cost below the minimum wage. The supply of workers above the minimum wage, however, may be great enough that the employer could claim the benefit of the credit without offering increased wages. See JOINT COMM. ON TAXATION, *supra*

Enterprise zones seek to create new businesses as well as new jobs. Thus, if income tax incentives, particularly incentives for investment, encourage the creation of new businesses in the zone by reducing risk and increasing the rate of return on investment, they could well have a place in enterprise zone legislation, even if labor garners little benefit. As discussed earlier, small businesses may offer zone residents benefits as consumers even if the businesses do not benefit them as workers.⁷⁸

Income taxes, however, represent a current cost only if the business is profitable. An income tax incentive, be it for labor or capital, does no immediate good to a business that has no income tax liability, unless it takes the form of a refundable credit.⁷⁹ Small, start-up businesses seldom incur income tax liabilities in their first years.⁸⁰ Enterprise zone legislation that relies on income tax breaks will not increase short-term profits and thus will do little to encourage the formation of new small businesses. Section 936 has benefitted large and profitable pharmaceutical companies.⁸¹ Unless such large companies contribute to the neighborhood through stability or in some other way,⁸² they will not benefit the inner cities merely by their presence in the neighborhood. If we wish to attract such large companies in order to create jobs, wage credits will be more effective.

note 11, at 44. If we assume that many unemployed residents of inner cities are unskilled, however, the wage credit is likely to benefit them. A bad job is better than no job. If the credit is given to the employee in order to avoid the stigma, it may not provide an incentive to hire minimum wage workers. Despite such potential problems with labor incentives, a recent study of Indiana's enterprise zones found that its tax incentives were ineffective in providing benefits to zone residents and urged that the main stimulus for such zones consist of a wage subsidy coupled with job training programs. See J. Andrew Hoerner, *NBER Economists Rate R&D Credit, Enterprise Zones, Saving Incentives*, 57 TAX NOTES 1115 (1992).

78. See *supra* text accompanying notes 18-20.

79. Moreover, if the tax incentive takes the form of a deduction rather than a credit, it will be more valuable to taxpayers at higher marginal rates because it will save such taxpayers more in taxes and thus create a greater percentage increase in after-tax profits.

80. As David Maloney notes,

EZ tax incentives may not be advantageous to new businesses because many such firms are in a net operating loss position in their early years and thus could not gain an immediate benefit from the available incentives. . . . Thus, it has been asserted that the incentives would do little to aid business start-ups or encourage people who were considering forming new companies to do so in the zones.

Maloney, *supra* note 11, at 272.

81. See *supra* text accompanying notes 28-34.

82. Some suggest that larger, capital-intensive businesses will in fact create stability. Because of their large investments, they are less likely to move even if the tax incentives end. They also tend to require skilled workers and pay higher wages. Residents of inner cities, however, are unlikely to have the requisite skills. Capital-intensive industries may displace current residents. Large tax incentives may be necessary to overcome problems of labor supply and transportation. If an area becomes dependent upon a particular industry and that industry moves or suffers economic woes, the residents will suffer. See JOINT COMM. ON TAXATION, *supra* note 11, at 42.

Some incentives for capital, moreover, will not currently benefit even those zone businesses that have current income tax liabilities. Capital gains preferences, in particular, benefit investors only in the future, if and when the business is sold at a profit. A capital gains preference therefore offers potential tax benefits to the owner of a small business who has no current profit but anticipates future profits. Since people start small businesses to generate long-term profits, the argument goes, a capital gains incentive increases the projected rate of return by reducing tax burdens on future profits.⁸³ If such is the case, a capital gains preference will attract outside capital.

Small businesses, however, have high rates of failure.⁸⁴ Thus, there is tremendous uncertainty as to whether a capital gains preference will benefit a particular small business. Given the uncertainty, the market may not value the potential capital gains preference, and the preference will do little to attract investment for the kinds of businesses we most want to attract. Indeed, the high rate of failure for small businesses suggests that any enterprise zone package should include a provision that makes tax losses more valuable to taxpayers.⁸⁵

Even if the market does value the capital gains preference, its effect may not be to promote the goals of enterprise zone legislation. Insofar as the market values the capital gains differential, the incentive will produce a windfall. Capital gains differentials increase return. They make the investment more valuable, and the price of the property will therefore rise to reflect the increased return and value.⁸⁶ A newly-enacted capital gains preference will accrue to whoever owns the property when the preference is enacted. Such an owner will have paid a price that did not reflect a higher return because of the capital gains differential, but will sell at a price that reflects this benefit. Moreover, the owner can realize

83. See JOINT COMM. ON TAXATION, *supra* note 11, at 45, 49, 52.

84. See HARVEY A. GARN & LARRY C. LEDEBAR, *THE ROLE OF SMALL BUSINESS ENTERPRISE IN ECONOMIC DEVELOPMENT* (1981). This study found that only 37% of new small businesses survive for more than four years and only 17% for more than nine years. *Id.* at 14.

85. Under current law, capital losses, with some exceptions, can be used only to offset capital gains. I.R.C. § 1211 (1992). Individuals, however, may use capital losses against \$3,000 of ordinary income. *Id.* Losses on certain small business stock can be treated as ordinary losses. I.R.C. § 1244 (1992). An entrepreneur may not have capital gains in the same year as capital losses. If the capital losses can be used currently against ordinary income, their benefit will increase. Small businesses not organized in corporate form are not able to take advantage of a special provision that permits loss on the sale of small business stock to be treated as an ordinary loss. See *Id.*

86. This effect is known as the tax preference being capitalized. See MARVIN CHIRELSTEIN, *Note: What is the True Value of a Tax Preference*, in *FEDERAL INCOME TAXATION: A LAW STUDENT'S GUIDE TO THE LEADING CASES AND CONCEPTS* 356-62 (6th ed. 1991).

the benefit of the capital gains preference only by disposing of the property, by selling it rather than by using the property to create economic activity. A capital gains preference thus rewards the seller who is ending ties to the community and burdens the buyer who would establish such ties.

Furthermore, few of the struggling businesses in our inner cities can afford to own the real property where they are located. The capital gains differential and the other tax breaks of enterprise zones, however, will enable owners of real property to charge higher rents to businesses operating in the zones. Higher rents increase the operating costs for zone businesses and could displace some renters. When rents rose in the enterprise zone of South Wales, authorities responded by enacting a rent freeze.⁸⁷ That is, the government reintroduced regulation in an area where development was premised on eliminating regulation.

In the long run, it appears, the tax incentives of enterprise zones would benefit owners of the land rather than the residents of the zones. As the Joint Committee on Taxation has explained,

In general, the incidence of a tax (or subsidy) falls most heavily on the factor of production that is least mobile. . . . Within an enterprise zone, land is an immobile factor and it may be expected that a tax benefit granted for economic activity undertaken in an enterprise zone will tend to result in higher prices for land in the enterprise zone.⁸⁸

Other suggested incentives for capital investment in enterprise zones would give credits or increased deductions for investment in equipment and other tangible property.⁸⁹ Investment tax credits encourage investment in machines rather than people. Consequently, they help machine-intensive industries, such as manufacturing. They are of relatively little benefit to labor-intensive retail and service businesses. If we seek to nourish the latter businesses in enterprise zones, investment tax credits will cut against such a goal. Moreover, investment tax credits cannot compensate for such deficiencies as poor public services or lack of a skilled work force.

The bill sponsored by the Bush Administration following the Los Angeles civil disturbances emphasized investment incentives.⁹⁰ A generous capital gains preference formed its centerpiece. Housing and Urban

87. Maloney, *supra* note 11, at 275 n.63.

88. JOINT COMM. ON TAXATION, *supra* note 11, at 143.

89. See Maloney, *supra* note 11, at 269.

90. The bill was introduced by Senator Bob Dole on June 19, 1992 in an amendment to the Senate's unemployment bill. Dole Amendment, *supra* note 41, reprinted in 138 CONG. REC. at

Development Secretary Jack Kemp testified that "[t]he first and essential step in freeing people from the rules that now prevent prosperity from appearing in urban and rural areas of poverty is the complete elimination of the capital gains tax on investing, working and living in enterprise zones."⁹¹ Accordingly, the Bush administration's bill proposed a 100% exclusion from federal income tax of capital gains realized by enterprise zone businesses on tangible and intangible property held at least two years; loss on disposition of such property would be treated as ordinary.⁹² In addition, subject to certain limits, investors could have either excluded capital gains realized when they disposed of stock in enterprise zone corporations⁹³ or deducted their contributions to the capital of enterprise zone businesses.⁹⁴

The Bush administration bill gave little attention to workers, but it did not ignore them completely. It expanded the earned income credit for employees of enterprise zone businesses and thus permitted low-wage earners to reduce their income taxes or, in some cases, to get a tax refund.⁹⁵ More importantly, the bill's definition of enterprise zone businesses tied capital incentives to the employment of zone residents. For a

S8558 (daily ed. June 19, 1992). The amendment was rejected by the Senate that day. 138 CONG. REC. D756 (daily ed. June 19, 1992).

91. Kemp, *supra* note 13. According to his written testimony, a "capital gains tax perpetuates Jim Crowism and racial discrimination." *Id.* Kemp saw the capital incentives of the Administration bill as helping small businesses: "The Bush Administration is under no illusion that Enterprise Zones would coax large, existing firms to move to Enterprise Zones." Jack Kemp, *Zone Defense*, THE NEW REPUBLIC, October 12, 1992, at 5, 5 (daily ed. June 19, 1992) (letter to the editor).

92. Dole Amendment, *supra* note 41, reprinted in 138 CONG. REC. at S8564 (daily ed. June 19, 1992) (to have been codified at I.R.C. § 1394). Real property would have had to be held for five years to qualify for this exclusion. *Id.* at S8562 (to have been codified at I.R.C. § 1391(d)). Given the experience in Puerto Rico, the inclusion of intangible assets is especially troubling, since businesses that exploit such assets are not usually labor-intensive. See *supra* text accompanying notes 27-34, 72-73.

93. *Id.* at S8563 (to have been codified at I.R.C. § 1392).

94. *Id.* Limits on this deduction would have been \$50,000 for any taxable year and \$250,000 lifetime. *Id.* The proceeds of the stock issuance would have to have been used within 12 months to acquire tangible property. Only business with one class of stock and no more than \$5 million in property would have been entitled to this provision. *Id.* However, these incentives for investors require that the businesses be organized as corporations, and many small start-up businesses are not so organized.

95. *Id.* at S8565 (to have been codified at I.R.C. § 32(b)). Under current law, only a low-income taxpayer who has both earned income (e.g., wages) and a child can qualify for the refundable earned income credit of § 32. In 1992, workers with a child who earn more than \$22,370 will not be entitled to any earned income credit. If workers who qualify for the credit have income tax liability less than the credit, they will receive a refund. In 1990, the credit provided a maximum of \$953 and an average of over \$550 to roughly 10 million families with low-wage heads of households. SAUL D. HOFFMAN & LAURENCE S. SEIDMAN, THE EARNED INCOME TAX CREDIT: ANTIPOVERTY EFFECTIVENESS AND LABOR MARKET EFFECTS 2 (1990). Under the Bush administration's bill, a childless worker in the enterprise zone would have qualified for the credit, but not childless workers outside

business to qualify as an enterprise zone business, at least eighty percent of its annual gross income had to be derived from, and substantially all of its property and employees involved in, the conduct of an active trade or business within the zone.⁹⁶ One-third of its employees had to be zone residents.⁹⁷ Only businesses meeting these qualifications were eligible for the investment incentives.⁹⁸

The enterprise zone legislation that passed the House of Representatives on July 3, 1992 differed from the Bush administration's proposal in an important way. The mainstay of the House bill was an employment credit for the employer of up to \$3000 per employee per year for wages paid to employees who both lived and worked within the zone.⁹⁹ The House bill, however, included investment incentives as well. Subject to certain limits, individuals could have deducted investments in stock of corporations doing business in the zone.¹⁰⁰ Capital gains were excluded upon disposition of stock of an enterprise zone business or property used in the zone if the proceeds of the disposition were reinvested in an enterprise zone within six months.¹⁰¹ Tangible assets used in the zone were

the zone. Dole Amendment, *supra* note 41, reprinted in 138 CONG. REC. S8565 (daily ed. June 19, 1992).

96. Dole Amendment, *supra* note 41, reprinted in 138 CONG. REC. S8565 (daily ed. June 19, 1992) (to have been codified at IRC § 1391(b)). Mayor Tom Bradley urged such a requirement in his testimony before the Senate Finance Committee on June 3, 1992:

It is imperative that any enterprise zone legislation include specific requirements for businesses to employ local residents to receive tax incentives. It has been said over and over again that unless the community has a stake in the businesses and the development of their neighborhoods we have failed to make a change in the lives of the families living in our cities. I CANNOT EMPHASIZE THIS POINT STRONGLY OR ENOUGH FOR YOU TODAY.

L.A. Mayor's Testimony Before the Finance Committee on Enterprise Zones, 92 TAX NOTES TODAY 116-96 (1992), available in LEXIS, Nexis Library, TNT File (emphasis in original).

97. Dole Amendment, *supra* note 41, reprinted in 138 CONG. REC. S8565 (daily ed. June 19, 1992).

98. Other tax incentives in the Bush administration's bill included excluding gains on the sale of enterprise zone residences. *Id.* at S8565 (to have been codified at I.R.C. § 1395), increasing expensing allowances, *id.* (to have been codified at IRC § 179(b)), permitting \$10,000 in passive losses, *id.* (to have been codified at IRC § 469(i)), and the issuance of tax-exempt bonds for enterprise zone businesses to purchase tangible property, *id.*

99. H.R. 11, *supra* note 2, reprinted in 138 CONG. REC. H5869-70 (daily ed. June 2, 1992) (to have been codified at I.R.C. § 1394).

100. *Id.* at H5870 (to have been codified at I.R.C. § 1396). Zone limits were \$30,000,000 for any calendar year. Individual limits were \$25,000 a year or \$250,000 lifetime. *Id.*

101. *Id.* at H5871-72 (to have been codified at I.R.C. § 1397A). The reinvestment requirement would have ensured that the benefits accrued to the enterprise zone as well as to the investor by requiring that the investor not cease to have ties to the community.

eligible for a fifty percent capital exclusion if held for five years.¹⁰² Losses on zone assets were treated as ordinary.¹⁰³

The House bill improved upon the Bush administration bill in several respects. Its wage credits addressed the issue of jobs more directly than the Bush administration bill. By requiring that capital gains be reinvested, it avoided giving investors an incentive to break their ties to the community. Limiting the capital gains exclusion to tangible assets guarded against the kind of problems that have been encountered with § 936. Nonetheless, the House bill would not have provided current benefits to small businesses without tax liability.

The Senate bill increased the emphasis on incentives to hire local workers. It expanded the wage credit, giving employers a credit of up to \$4500 for each employee who both lived and worked in the zone.¹⁰⁴ The employer need not have been an enterprise zone business, however, and, importantly, the wage credit would have been refundable for certain small businesses.¹⁰⁵ Like the House bill, the Senate bill also permitted investment incentives for enterprise zone businesses.¹⁰⁶ The incentives, however, were limited. There was no capital gain exclusion, but individuals were allowed a fifty percent deduction for amounts paid to purchase certain stock in an enterprise zone business.¹⁰⁷ Enterprise zone businesses could have deducted certain equipment expenses and depreciated other property more quickly than other businesses.¹⁰⁸

Senator Bentsen, Chairman of the Senate Finance Committee, voiced his doubts about investment incentives, particularly a capital

102. *Id.* at H5871 (to have been codified at I.R.C. § 1397). Like the Bush administration bill, the House bill provided for ordinary loss treatment for zone investments, increased the ability to take current deductions for the purchase of certain business property, and permitted use of tax-exempt financing for certain enterprise zone facilities. *Id.*

103. *Id.* at H5872 (to have been codified at I.R.C. § 1397B). As in the Bush administration bill, the ability to expense certain investment was increased, *id.*, and tax-exempt bonds for enterprise zones were authorized, *id.* at H5873.

104. Amendment to H.R. 11, *supra* note 5, reprinted in 138 CONG. REC. S12,125-26 (daily ed. Aug. 11, 1992) (to have been codified at I.R.C. § 1395).

105. *Id.* (to have been codified at I.R.C. § 1395(c), (d)).

106. Like the Bush administration bill and the House bill, the Senate bill required that enterprise zone businesses engage in the active conduct of a trade within the zone, that at least 80% of the gross income of the entity be derived from such business, and that at least one-third of the employees be residents of the zone. *Id.* at S12,126 (to have been codified at I.R.C. § 1397(c)).

107. *Id.* at S12,126-27 (to have been codified at I.R.C. § 1397B).

108. *Id.* at S12,126 (to have been codified at I.R.C. §§ 1397, 1397A). Like the other bills discussed above, the Senate bill would have treated losses on disposition of enterprise zone tangible property and stock as ordinary instead of capital. *Id.* at S12,127-28 (to have been codified at I.R.C. § 1397D). The Senate bill also would have permitted tax enterprise zone bonds. *Id.* at S12,128 (to have been codified at I.R.C. § 1103).

gains preference, for distressed neighborhoods. He explained his decision to exclude the proposed capital gain preference by saying, "We can get more bang for the buck by putting the incentives up front," while capital gain incentives would pay off only "10 years down the line" and "have no effect on making more jobs."¹⁰⁹

The Senate bill reflected this skepticism by relying on wage incentives. Both the reliance on wage credits and the skepticism about capital gains were appropriate. Moreover, by making credits refundable, the Senate offered current benefits to small businesses. The House-Senate Conference Committee, however, accepted the House version of the enterprise zone program for inclusion in H.R. 11, the Revenue Reconciliation Act of 1992.¹¹⁰ The large number of zones in the Senate bill made it too expensive.

The enterprise zones included in the bill sent to President Bush had many features in common with the Bush administration's. Like the Bush administration bill, it included investment incentives and a capital gains preference. Nonetheless, President Bush pocket-vetoed H.R. 11 on the ground that other provisions of the bill constituted tax raises.¹¹¹

IV. CONCLUSION

If enterprise zones merely provide income tax incentives, they will do little to produce new businesses and new jobs. Experience with enterprise zones both in this country and elsewhere suggests that we not pursue this route. If we do, we should proceed with skepticism and extreme caution. If we go the route of tax incentives, we err in emphasizing subsidies for capital instead of subsidies for labor. And we heighten the error by adopting capital subsidies that fail to aid small entrepreneurs in establishing their own businesses. Loans from community development banks, for example, are likely to provide small businesses with more affordable capital than would tax incentives. Wage credits also have limits. They encourage employers to offer low-wage jobs, but not to train workers for better jobs.

Studies have shown that businesses deciding where to locate look for skilled labor, transportation, and safety. Thus, business needs match the needs of inner-city residents. Even after the civil disturbances in Los Angeles highlighted the problems of our inner cities, the 102d Congress

109. *Bentsen, supra* note 46.

110. *See supra* note 8.

111. *See supra* note 9.

and President Bush failed to enact a legislative program to address the situation. This failure disappoints. That they failed to enact tax enterprise zones, however, offers an opportunity to develop a more comprehensive program.

POSTSCRIPT

In May 1993, the Clinton Administration announced a proposal for empowerment zones and enterprise communities. The Clinton plan calls for designation of ten empowerment zones and one hundred enterprise communities.¹¹² Businesses located within empowerment zones that employ zone residents would be eligible for wage credits of up to \$5,000 per year for each such employee; businesses outside the zone could obtain a credit of up to \$2,400 for first-year wages of zone residents.¹¹³ The plan includes no capital gains preferences, but businesses located within empowerment zones, at least 35% of whose employees are residents of the zones, would be eligible to increased expensing of equipment and accelerated depreciation. Enterprise communities would not be eligible for tax breaks, but would receive priority for such federal programs as community policing, community development banks, drug prevention, worker training, housing, and child care.¹¹⁴ In addition, enterprise communities that submit an integrated plan for business and social services could obtain waivers from complicated regulations and requirements of various federal programs.¹¹⁵

The Clinton plan is a modest one, totalling \$8.1 billion over five years.¹¹⁶ However, its approach for improving the country's most distressed neighborhoods follows the approach suggested in this Article. The plan proposes limited tax incentives, emphasizes incentives for labor, and accompanies the tax program with new spending programs and coordination of existing programs. It is a step in the right direction.

112. *Reconciliation Recommendation of the Committee on Ways and Means*, 93 TAX NOTES TODAY 108-25, available in LEXIS, Fedtax Library, TNT File. The Secretary of Housing and Urban Development would designate six urban empowerment zones and sixty-five enterprise communities. *Id.* The urban area zones could have a maximum population of 200,000 and would have to have a poverty rate of at least 20%. *Id.*

113. *Id.*

114. Paul Richter, *Clinton Unveils Aid Plan for Poor Areas*, L.A. TIMES, May 5, 1993, at A23.

115. Jason DeParle, *Clinton Proposes Assistance to Troubled Neighborhoods*, N.Y. TIMES, May 5, 1993, at B9. Of that amount, \$4.1 billion would be from tax incentives, \$1 billion for new spending, and \$3 billion from earmarking existing programs to the selected areas. *Id.*

116. *Id.*

