

THE WHITE HOUSE  
WASHINGTON

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MDT

MEMORANDUM FOR JAMES BAKER III

FROM:

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PROJECT MANAGER OF THE WORKING GROUP ON  
IMPLEMENTATION OF ENTERPRISE ZONES

SUBJECT:

The Administration Plan for Enterprise Zones

Attached is the executive summary of the Administration's plan for Enterprise Zones and a copy of the plan. It was approved as a result of the meeting of the Cabinet Council on Commerce and Trade held December 23, 1981.

January 15, 1982

## The Administration Plan for Enterprise Zones Executive Summary

Concept and Purpose. The Enterprise Zone plan is an experimental, free-market program for dealing with some aspects of problems in inner cities.

The purpose of the program is twofold. One objective is to create jobs in the nation's depressed, inner city areas, particularly jobs for disadvantaged workers. Another objective is to redevelop and revitalize the geographic zone areas themselves.

The underlying concept of Enterprise Zones is to create a wide-open, free-market environment in depressed areas through relief from taxes, regulations and other government burdens, privatization of some city services and involvement of private, neighborhood organizations. Because the program is based on the concept of removing government burdens rather than providing government subsidies, it should involve no appropriations, at least at the Federal level.

The incentives and natural market forces thus unleashed in central cities would then be relied upon to stimulate economic activity within the zones and accomplish the program's objectives. This would be similar to the free trade zones established in other parts of the world, such as Hong Kong, which have been quite successful in stimulating the development of poor areas.

The program is intended primarily to stimulate new economic activity within the zones that would not otherwise have occurred at all, anywhere, rather than to encourage existing outside activity to relocate into the zones. In addition, the intent behind the program is not to stimulate a particular kind of business, but rather to let the market decide what activities should take place in the zones. While the Federal tax incentives are skewed towards labor-intensive businesses and jobs for disadvantaged workers, the program generally is meant to include a relatively balanced set of incentives for a broad range of economic activities and businesses.

Program Structure. The Federal legislation would establish what areas would be eligible to be declared Enterprise Zones based on criteria concerning poverty, unemployment and economic distress. This would not be an entitlement program and, consequently, eligible areas would not automatically become Enterprise Zones. Rather, an eligible area would first have to be designated by a state government with local approval or by a local government with state approval. Both the designating and approving governments would then have to apply to the Secretary of HUD for Federal approval.

The Federal approval process would be competitive, with the quality and strength of the incentives to be contributed to the proposed zones by the state and local governments as the primary criteria for selection. Particular emphasis would be given to incentives and contributions consistent with the overall Enterprise Zone theme of creating an open market environment through the removal of government burdens. These contributions would include tax relief, regulatory relief, possible experimentation with private sector providers of public services, and involvement in the program of neighborhood and community groups. Other contributions and factors would also be considered in this competition.

A maximum of 25 zones would be approved in each of the first three years of the program. Each zone would last for the period chosen by the designating state and local governments, with a maximum of 20 years plus a four-year phaseout of Federal participation. HUD would be the agency administering the program.

Federal Tax Incentives. The major features of the Federal tax package are:

- o a nonrefundable investment tax credit for capital investments in an Enterprise Zone, applying to the construction or rehabilitation of commercial, industrial or rental housing structures within a zone, as well as investments in machinery and equipment,
- o a nonrefundable income tax credit to employers for payroll paid to zone employees in excess of payroll paid to such employees in the year prior to zone designation,
- o a special, strengthened, nonrefundable income tax credit for wages paid to zone employees who were disadvantaged individuals when hired,
- o a nonrefundable, income tax credit to zone employees for wages earned in zone employment,
- o the elimination of capital gains taxes within the zones,
- o the designation of suitable Enterprise Zone areas as Foreign Trade Zones, providing relief from tariffs and import duties,
- o the continued availability of Industrial Development Bonds to small businesses in Enterprise Zones even if the availability of such bonds is terminated elsewhere.

The Treasury Department's "worst case" estimates are that the cost of an Enterprise Zone with this tax package would be \$9.8 million to \$13.3 million per year in terms of foregone tax revenue. The cost of 10 to 25 Enterprise Zones in the first year of the program would, therefore, be \$98 million to \$332.5 million.

As a whole, the effect of this tax package for most Enterprise Zone firms would be to eliminate 75 percent or more of the corporate income tax, eliminate entirely the capital gains tax, provide relief from tariffs and duties, create easier access to start-up capital, and provide income tax relief to the firm's employees.

Federal Regulatory Relief. Under the Administration plan, Federal regulatory bodies (all agencies covered by the Administrative Procedures Act) would be given discretionary authority to relax or eliminate their regulatory requirements within Enterprise Zones, in accordance with standards promulgated by Congress, but only upon the request of the state and local governments.

To utilize this authority, the state and local governments governing each zone would initially ask Federal regulatory bodies to relax or eliminate particular regulations within the zone. The Federal bodies would have the statutory power to grant such requests at their discretion. Congressionally mandated standards would dictate how the agencies would use this discretion, requiring them to consider and avoid significant detrimental impacts on the public health, safety,

welfare, etc. The standards would include an instruction to each body to weigh the special economic redevelopment purpose of the zones against the other important considerations and to relax or eliminate each particular regulation within a zone when appropriate. A Federal regulatory body would have no authority to take any action without a prior request from both the state and local governments governing each zone.

The only regulations which would not be affected by this authority would be those specifically imposed and spelled out by statute. The authority could be broadened to include such regulations if each such statute were expressly amended by the Enterprise Zone legislation. The Administration proposes that this be done in only one case.

This one case is the applicability of the minimum wage law to teenage employment within Enterprise Zones. Under the Administration plan, the Labor Department would be given discretionary authority to relax or eliminate applicability of the law to such employment. The authority could again be exercised only upon the request of both the state and local government governing each zone. The Department's discretion would also be delimited by Congressionally mandated standards, requiring the Department to weigh the public health, safety and welfare, and the economic well-being of workers, as well as the creation of jobs and economic activity within Enterprise Zones.

State and Local Government Role. The Enterprise Zone program is not simply a Federal Government effort. To be successful, the program must have substantial contributions from state and local governments. In fact, state and local contributions would probably make the critical difference in whether a zone succeeds or fails.

The initial importance of the state and local contributions is that they would determine what designated zones would be Federally approved. It should be emphasized that the Federal posture towards these contributions would be highly flexible. No particular element of tax relief or regulatory relief, or any other possible contribution, would be required. Failure to include one element in a state and local package of contributions could be offset by greater strength in the other elements. It should be remembered, however, that the state and local contribution packages would be competitively evaluated against each other.

In the area of tax relief, state and local governments could provide reductions in state and local income taxes, property taxes, sales taxes, and other taxes which vary among the jurisdictions. State and local deregulation could be provided in such areas as zoning, occupational licensure laws, rent controls, usury laws, minimum wage laws, other price controls, permit requirements, central planning regulations and building codes. In the area of service improvement, "contracting out" or "privatization" could be one means of achieving the desired result.

To encourage local community involvement, and to assure that the end result of an Enterprise Zone would not be merely gentrification-plus-displacement, state and local governments could provide for the creation of "Neighborhood Enterprise Associations" by zone residents. These Associations could undertake the provision of some city services in their areas, help local residents to participate in the economic success of the zones, particularly through mechanisms providing for equity participation by zone residents, and support volunteer, self-help efforts for the zone areas. Participation in the program by other private sector organizations which could perform these functions could also be encouraged by the state and local governments.

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## The Administration Plan for Enterprise Zones

The Enterprise Zone concept has the potential for developing into a comprehensive, highly successful and yet thoroughly free-market program for dealing with urban problems. The purpose of this memorandum is to outline the Administration's plan for an experimental Enterprise Zone program.

### Purpose Concept, and Elements

Purpose. The purpose of the Enterprise Zone program is twofold. One objective is to create jobs in the nation's depressed inner city areas, particularly jobs for disadvantaged workers. But another objective is to redevelop and revitalize the geographic zone areas themselves.

The intent behind the program is to stimulate new economic activity within the zones that would not have otherwise occurred at all, anywhere, rather than to encourage existing outside activity to relocate into the zones. However, it is quite possible that some entrepreneurs considering the establishment of entirely new businesses and some existing firms considering major expansions will locate their new facilities within the zones, even though they would have gone ahead with these projects elsewhere in the absence of the program. While relocation in this sense is not as purely beneficial as the stimulation of entirely new activity, bringing such economic development to the depressed areas of our major cities has important social benefits and would, therefore, still be an advantageous result of the program. Such relocation is the sole focus of existing urban revitalization programs.

In addition, the intent behind the program is not to attempt to stimulate a particular kind of business, but rather to let the market decide what activities should take place in the zones. The Federal tax incentives in the Administration plan are skewed towards the encouragement of labor-intensive activities and the creation of jobs for disadvantaged workers. But apart from this, the program is meant to include a relatively balanced set of incentives for a broad range of economic activities and businesses. There should be no attempt to exclude incentives for large businesses, but at the same time innovations are necessary to ensure that there are meaningful incentives for small businesses. Incentives for housing and commercial real estate development should not be ignored, especially considering the great need for such activity in potential zone areas.

This balanced approach will avoid perversion of the program into a form of central economic planning which attempts to dictate the location of particular types of economic activity. It is also more likely to result in the stimulation of permanent and enduring economic activity, organically integrated into the national economy and the local community.

The program is to be viewed as an experimental one, at least in its initial years.

Concept. The Enterprise Zone concept is based on utilizing the market to solve urban problems, relying primarily on private sector institutions. The idea is to create a wide-open, free market environment in depressed inner city areas through the removal of taxes, regulations and other government burdens. The incentives and natural market forces thus unleashed in central cities would then be relied upon to lead to the economic redevelopment of these areas and to real, private sector jobs for the disadvantaged individuals in or near those areas. This would be similar to the free trade zones established in other parts of the world, such as Hong Kong, which have been quite successful in stimulating the development of poor areas.

Enterprise Zones are thus based on an entirely fresh paradigm of thought concerning economic growth and the inner cities. The old approach was based on two elements--subsidy and central planning. This involved taxing away part of the hard-earned income of workers and producers to give subsidies to others in need, maintaining or increasing their economic dependency. It also involved massively bureaucratic urban renewal projects and other central planning tools aimed at redirecting existing economic activity.

The new approach is instead based on market processes. Instead of subsidy, it focuses on removing government barriers to economic growth, barriers which are preventing people from creating, producing and earning their own wages and profits. The approach is to focus on what the government is doing that inhibits economic growth, that prevents people from achieving the kinds of things they want. And instead of central planning, the new approach seeks to create a general climate of open markets where entrepreneurs and economic activity could flourish, relying on market forces to determine the course of redevelopment within the zones.

The concept involves not just removing taxes and regulations within the zone areas, but also attempting to solve problems and provide services through increased reliance on decentralized, voluntary, private, market institutions rather than highly centralized, bureaucratic, coercive, government institutions. An additional category of government barriers to economic growth is inadequate municipal services which the government has monopolized and thereby foreclosed to alternative providers. The Enterprise Zone program could, therefore, involve experimentation with the private provision of municipal services, where feasible and prudent. It could also involve utilization of private, local community organizations to facilitate participation by zone residents in the economic development of the zone areas and to help deal with social problems in those areas.

No Appropriations. The basic concept of the program demands that it involve no appropriations, at least at the Federal level, except for necessary administrative expenses. Such appropriations were characteristic of the old approach of providing direct subsidies, rather than the new Enterprise Zone approach of removing government burdens. If new subsidies were offered under the auspices of Enterprise Zones, they would grow rapidly along with the rest of the program, thereby undermining the Administration's economic recovery efforts. States and cities would still have the option of allocating their discretionary Federal funds to their Enterprise Zones if they desired to do so, or to appropriate additional funds for such zones on their own.

One of the primary uses for which such subsidies are often suggested is start-up, front-end capital for businesses. But such capital could better be made available to deserving businesses through tax incentives and regulatory relief for financial institutions. Another possible area often suggested for subsidization is grants to cities for infrastructure. But the growth in new, booming cities also needs accommodating infrastructure, which has to be built anew. Special Federal subsidies for this infrastructure are, therefore, not necessary to accommodate renewed economic growth in the older, economically declining cities.

Elements. A comprehensive Enterprise Zone program would, therefore, contain the following elements:

- (1) tax relief at the Federal, state, and local levels;
- (2) regulatory relief at the Federal, state, and local levels;
- (3) efforts to improve public services, possibly including experimentation with private alternatives for those services;
- (4) involvement in the program by private, local, neighborhood organizations.

These four elements should together provide incentives and opportunities in each of the following categories:

- (1) incentives for employers to establish businesses and create jobs in the zone areas;
- (2) incentives for suppliers of key commodities, such as loans and insurance, to supply such commodities to zone businesses;
- (3) incentives for employees, particularly the currently poor and/or unemployed to obtain jobs within the zone areas;
- (4) opportunities for zone residents and other disadvantaged individuals in the zone areas to participate in the economic success of the zones.

In addition to these elements, the Enterprise Zone program should be consistent with the Administration's other policies, such as Federalism and the Economic Recovery Program.

### Program Structure

This section will discuss how the zones would be established and administered under the Administration's plan.

1. The Eligibility Criteria. Initially, areas which meet certain criteria would be eligible to become Enterprise Zones under the Federal program. These eligibility criteria would be the same as in the 1981 Kemp-Garcia bill (HR 3824, S1310; See Tab). To be eligible, an area must be one of pervasive poverty, unemployment and general distress, as determined by the Secretary of HUD. The area must also be within a jurisdiction which satisfies the eligibility criteria under the UDAG program. (See Appendix A). The area must then satisfy one of four additional criteria:

- (a) the average rate of unemployment in the area for the most recent 18-month period for which data are available was at least one and one-half times the national average for that period, or
- (b) the area was a low-income poverty area as determined by the Bureau of Census during its most recent census, or
- (c) at least 70 percent of the residents of the area have incomes below 80 percent of the median income of the residents in the jurisdiction of the government designating the area, or
- (d) the population of all census tracts in the area decreased by at least 10 percent between 1970 and 1980 and the designating government establishes to the satisfaction of the Secretary of HUD that either:
  - (i) chronic abandonment or demolition of commercial or residential structures exists in the area, or
  - (ii) substantial tax arrearages of commercial or residential structures exists in the area.

The eligible areas, however, would not automatically become Enterprise Zones, as this would not be an entitlement program. The actual Enterprise Zones would instead be designated within these eligible areas by the process discussed below.

The Kemp-Garcia eligibility criteria were developed based on considerable advice from cities and urban and minority groups. They give considerable discretion to state and city governments to select the areas believed to be most suitable for Enterprise Zone status.

2. The Designation Process. An Enterprise Zone could initially be designated by the city government with state consent or by the state government with city consent. These designations or approvals would have to be by legislative action, although the state or city government could pass general legislation authorizing some body or individual to designate or approve each zone. Both the state and city governments would also usually have to pass legislation creating the state and local incentives to be contributed to each zone.

Both the designating and approving governments would then apply to the Secretary of HUD for Federal approval of the designated Enterprise Zone, which would allow the Federal incentives to apply to the zone as well. Approval of such

applications would not be automatic or routine, however. Rather, the Secretary would evaluate the various applications on a competitive basis against each other, choosing the best applications for the limited number of Federal approvals available each year.

Before the Secretary could approve a zone, it must meet five threshold requirements:

- (1) the zone as a whole must satisfy the eligibility criteria noted above,
- (2) the designated zone area must be within the jurisdiction of both the designating and approving governments,
- (3) the boundary of the zone area must be continuous,
- (4) the zone area, if within an SMSA, must have a population of at least 4,000 or, if not within an SMSA, of at least 2,500, or must be entirely within an Indian reservation, and
- (5) both the designating and approving governments must establish incentives for the zone.

In competitively evaluating the applications beyond these threshold requirements, the Secretary will give primary emphasis to the quality and strength of the state and local incentives to be contributed to the zones. The Secretary will in particular emphasize incentives or contributions in the following four categories, which are consistent with the overall Enterprise Zone theme of creating an open market environment through the removal of government burdens:

- (1) tax relief
- (2) regulatory relief
- (3) improved public services, particularly through experimentation with privatization
- (4) involvement in the program by neighborhood organizations and other private sector groups which can make contributions to the zones.

A number of other factors will also be important, however, and will weigh heavily in the competitive process. These factors would include:

- (1) the fiscal ability of the state or local government to provide tax relief,
- (2) the degree of poverty and economic distress in the proposed Enterprise Zone,

- (3) the desirability, in the Secretary's judgement, of
  - (i) the location of the boundaries of the zone,
  - (ii) the size of the zone, and
  - (iii) the types of activities currently taking place in the zone,
- (4) incentives and contributions not included on the list above, such as job training or infrastructure grants or expenditures, to be committed to the zone,
- (5) effective and enforceable guarantees by the state and local governments that their proposed incentives and contributions will actually be provided for the indicated duration of the zone,
- (6) legitimate commitments by investors to start or expand business activities in the zone,
- (7) the overall likely success of the zone,
- (8) other factors to be determined by the Secretary which are
  - (i) consistent with the spirit of the Enterprise Zone program, in the Secretary's judgment,
  - (ii) important to minimizing the unnecessary loss of tax revenues to the Federal Government.

The importance of these latter elements should not be underestimated. The Secretary will have the discretionary power to deny a zone application based on one of these elements alone, such as excessive size of a zone or poor boundary location. Factors such as business commitments to the zone and the zone's overall potential success will naturally figure prominently in choosing between applications.

The Secretary's attitude toward the elements in the state and local incentive packages will be one of flexibility. The Secretary will not insist upon any particular item of tax or regulatory relief, for example. A weakness of incentives in one area, such as tax relief, could be offset by greater strength in another area, such as regulatory relief. It should be remembered, however, that the incentive packages will be evaluated competitively against each other with primary emphasis on the overall creation of a free market environment through the removal of government burdens. Moreover, the Secretary will not be required to grant any particular number of Federal approvals and could, therefore, reduce the number of approvals in any year if there were insufficient number of applications.

It should also be noted that the Secretary will have the power to revoke Federal approval of a zone if the state or local government does not honor its commitment with respect to its promised package of incentives and contributions.

3. Urban vs. Rural Focus. Many rural areas would satisfy the eligibility criteria for Enterprise Zones. Approximately 10,000 small cities with populations under 50,000 are eligible under the UDAG program and most of these would be eligible under the Enterprise Zone program. State and local governments could designate zones in these areas and compete for Federal approval along with zones designated in larger cities.

The Administration believes, however, that the program should be focused on large urban areas, at least in the initial years. The Secretary will, therefore, use his discretion to approve zones primarily in these large, urban areas. Some zones, however, will be approved each year in rural areas and state and local governments should be encouraged to make applications from those areas. The Administration intends to make its initial preference for urban areas part of the legislative history of the bill.

4. Number of Zones. Under the Administration's plan, the Secretary of HUD will be authorized to approve up to 25 zones each year for the application of the Federal incentives. The actual number designated will depend on the number and quality of the applications.

5. Duration of the Zones. Each Enterprise Zone will last for the period chosen by the designating and approving state and local governments. The Federal incentives will apply to an approved zone for this entire period, up to a maximum of 20 years plus a four year phaseout. During the phaseout period, the Federal tax reductions will be reduced by 25 percent each year.

6. HUD Administration. HUD will be the administering agency for the program and will be the lead agency in pursuing legislative adoption of the program. The Treasury Department will be responsible for the tax provisions of the bill and the IRS will administer these provisions.

### Federal Tax Incentives

1. The Administration's Enterprise Zone Tax Package. The following Federal tax incentives would apply within approved Enterprise Zones under the Administration's plan:

- (1) A special, additional, investment tax credit would be allowed for capital investments in an Enterprise Zone. For property depreciable in 3 years, this credit would be 3 percent. For property depreciable in 5 years, this credit would be 5 percent. For the construction or rehabilitation of commercial, industrial or rental housing structures within the zone, the credit would be 10 percent. Machinery and equipment eligible for the credit must be used in the zone for all of its depreciable life, or else a proportion of the credit will be subject to recapture.
- (2) Employers would be allowed a 10 percent nonrefundable tax credit for payroll paid to zone employees (qualified employees as defined below) in excess of payroll paid to zone employees in the year prior to

designation of the zone, with the credit calculated against a maximum of \$15,000 for each worker (2.5 times the FUTA wage base, which is currently \$6,000), thereby providing a maximum credit of \$1,500 per worker.

- (3) Employers would be allowed a nonrefundable tax credit for wages paid to zone employees (qualified employees as defined below) who were also disadvantaged workers (poor and hard-to-employ individuals as defined by the Department of Labor) when hired. The credit would be equal to 50 percent of such wages in each of the first three years of employment, declining by 10 percentage points in each year after that. The credit would apply only for disadvantaged workers hired after designation of the zone.
- (4) Zone employees (qualified employees as defined below) would be allowed a 5 percent nonrefundable income tax credit for taxable income earned in zone employment, with the maximum credit applicable to the first \$9,000 intaxable income (1.5 times the current FUTA wage base of \$6,000), thereby providing a maximum credit of \$450 per worker.
- (5) Capital gains taxes on the sale of zone property (qualified property as defined below) would be eliminated. The termination of an Enterprise Zone period will not terminate the eligibility of otherwise qualified property for this exemption, until the first sale or exchange of such property after such termination.
- (6) Industrial Development Bonds could be issued to finance small businesses (to be defined) located within Enterprise Zones, even if the use of IDB's elsewhere is terminated.
- (7) Any Enterprise Zone firm would be allowed an operating loss carryover for the life of the zone in which it is located, or 15 years, whichever is longer. The credits under items (1), (2), and (3) above could also be carried over for the life of the zone in which the firm is located.
- (8) The Foreign Trade Zone Board would be instructed that, whenever possible, Foreign Trade Zones should be established within Enterprise Zones and applications of such zones to become Foreign Trade Zones should be expedited and given special consideration.
- (9) Definitions--
  - (a) Qualified property is:
    - (i) any real or tangible personal property which is used predominantly by the taxpayer in an Enterprise Zone in the active conduct of a trade or business, and
    - (ii) any interest in a corporation, partnership, or other entity if, for the most recent taxable year of such entity ending before the date of the sale or exchange, such entity was

- (I) engaged in the active conduct of a trade or business within an Enterprise Zone,
  - (II) with no more than 20 percent of its income from passive investments,
  - (III) with substantially all of its tangible units located in an Enterprise Zone, and
  - (IV) with no corporate shareholders.
- (b) A qualified employee is any employee who performs more than 50 percent of his services within an Enterprise Zone.
  - (c) Ownership of rental property, whether residential, commercial or industrial, within an Enterprise Zone shall be treated as the active conduct of trade or business.
  - (d) The treatment of property as qualified property for purposes of the capital gains provision shall not be terminated at the end of the period for which the Enterprise Zone in which the property is located or used is in effect, but shall terminate after the first sale or exchange of such property occurring after such period.

2. Cost of the Tax Package. The Treasury Department's "worst-case" estimates are that the cost of an Enterprise Zone with this tax package would be \$9.8 million to \$13.3 million per year in terms of foregone tax revenue. The cost of 10 Enterprise Zones in the first year of the program would, therefore, be \$98 million to \$133 million. The cost of 25 Enterprise Zones in the first year of the program would be \$245 million to \$332.5 million. The total cost of the program would increase commensurately in future years for increased members of zones.

These estimates are based on the pessimistic assumption that little or no new economic activity will be created by the program that would not have occurred elsewhere. If the program is successful in its goal of stimulating such activity and employing unemployed resources, then this revenue loss will be significantly offset by the generation of new revenues and by reduced government expenditures due to the employment of individuals formerly receiving government aid. The cost of the program would, therefore, be even less. Eventually, the program could conceivably become a net revenue generator. In any event, all these estimates are very tentative and are based on numerous untested assumptions.

3. The Investment Tax Credit (Item 1). This item provides an incentive for capital investment in Enterprise Zones. At 3 percent for 3 year equipment and 5 percent for 5 year equipment, this portion of the credit in effect increases the current nationwide investment tax credit by 50 percent. To be eligible for the credit, the machinery or equipment must be used predominantly within the Enterprise Zone in a trade or business. This will prevent the taking of the credit for highly mobile capital with only superficial connections to the zones and whose main functions are actually outside zone. The machinery or equipment

must be used within the zone for all of its depreciable life. This will help avoid abuses such as purchasing the machinery or equipment through a business within the zone for use outside the zone. Premature removal from the zone of these capital items will result in a tax assessment which will recapture a portion of the tax benefits due to the credit, based on the portion of its life for which the capital was used in the zone, plus a penalty.

The portion of the credit relating to rehabilitation and construction will encourage the development of commercial and industrial structures in the zone areas. Such structures will be sorely needed in most Enterprise Zones. This incentive will be useful in increasing the availability of commercial space to small businesses, most of which rent such space.

This portion of the credit will also encourage the construction of rental housing in Enterprise Zones. Needless to say, housing is another critical need in most areas likely to be designated as Enterprise Zones. This includes housing for all income classes. Applying the zone incentives to housing across the board would tend to integrate zone areas racially and socioeconomically, as well as leading to the creation of new commercial opportunities for zone businesses in serving and supplying the residents of this housing.

The credit will apply only to capital investments made in a zone after it is designated and approved. Existing businesses in the zones will not receive any tax benefit for their past investments. These businesses will, however, be able to take the credit for any investments to replace worn out capital currently in use. If these businesses remain committed to the zones long enough to turn over their capital stock, they will enjoy the credit for their entire capital investment in the zones, just as a completely new business. Over time, therefore, existing businesses in the zones will receive a growing tax reduction due to the investment tax credit, commensurate with their continued commitment to the zones and eventually reaching the full tax reduction available to a new business.

4. The Employer Credit for Zone Wages (Item 2). The 10 percent credit to the employer for wages paid to zone employees will encourage the creation of jobs in Enterprise Zones for workers of all types. It will attract labor-intensive business activities to the Enterprise Zone areas. With a cap of \$15,000 on wages to which the credit applies, the incentive is focused on jobs for low and median income workers.

Since this \$15,000 cap is expressed in terms of the FUTA wage base (2.5 times the current FUTA base of \$6,000), the cap is indexed to increase with the rate of inflation, as the FUTA base is. With this cap, the maximum credit an employer can receive per worker is \$1,500.

The credit is available to all employers for the workers they employ within the zones, regardless of how many workers they employ elsewhere or what business activities they engage in outside of the zones. An international, multi-billion dollar corporation that employs one worker in an Enterprise Zone will receive the credit for the wages paid to that worker.

The credit does not apply, however, to the existing payroll of an existing business within a zone when it is designated. It would also not apply to a worker hired by such a firm to replace a former, pre-zone worker at the same wage. But it would apply to increases in wages paid to existing workers and wages paid to replacement workers above the total sum of wages paid to the former workers, all subject to the maximum annual wage cap per worker. Since wages tend to increase over time, this means that existing firms will receive some increasing tax reduction from this credit over time. The credit will also apply to wages paid by existing firms to net, additional workers, representing an increase in the firm's workforce, again subject to the annual maximum wage cap per worker.

This limitation on the applicability of the credit to existing businesses was imposed to avoid windfalls to such businesses already operating within the zone areas. It also substantially reduces the cost of the credit.

5. The Employer Credit for Disadvantaged Workers (Item 3). The special credit to the employer for wages paid to disadvantaged zone workers provides an additional incentive for the creation of jobs for these workers. Because of the availability of this credit, employers will be encouraged to establish basic job training programs to improve the productivity of these workers and make them more employable.

This credit is the strongest tax incentive ever provided for the hiring of disadvantaged workers. The 3-year duration and 4-year phaseout will provide the employer with enough time to undertake a long term training program addressed to the needs of the most disadvantaged workers. It will provide the employer with a payoff if he is successful in improving and maintaining the employability of the worker, since he can receive the credit for a number of years. The duration of this credit will also substantially limit any incentive to turn over disadvantaged employees in order to obtain the maximum credit. By the time the credit begins to decline, the employee's productive skills should have improved sufficiently to offset this decline.

The definition of disadvantaged workers for the purposes of this credit will be a revamped version of the CETA definition. This definition will be focused on low-income and hard to employ individuals. Because this definition will limit the applicability of this incentive to workers with low skills, and because the credit will last for only a limited number of years per worker, a cap on the wages to which it applies is unnecessary and would only be an administrative burden.

The credit will apply only to disadvantaged workers hired after designation of the zone in which they are employed. But these workers do not have to represent net, additional workers, or an increase in their employer's work force. The credit will apply even if they are merely replacement workers in a work force of constant size.

This credit will, therefore, not apply to the past payroll of an existing business in a zone. But if, for example, such a business replaces workers lost through attrition with disadvantaged workers, then it will receive an increased tax reduction from this credit. The credit will be available to

all employers for the disadvantaged workers they employ within the zones, regardless of the number of workers or amount of business conducted elsewhere.

6. The Employee Tax Credit (Item 4). The tax credit for the employee will increase wages to employees who work in the zones. This would increase the returns to low income workers for accepting a job and giving up welfare or other assistance benefits, thereby helping them to break out of the incentive structure of "the poverty trap." Tax breaks for this purpose have been advanced by the NAACP.

Such a benefit will also be important in inducing more highly skilled workers to accept employment within the zones, which may initially be somewhat undesirable places to work. Concern over the inability to otherwise attract such workers to these areas might be a substantial impediment to the formation of new businesses within the zones.

With a cap of \$9,000 on wages to which the credit applies, this incentive is concentrated on lower income workers. This cap is again indexed to the rate of inflation, as it is equal to 1.5 times the indexed FUTA wage base, which is currently \$6,000.

7. Capital Gains Tax Elimination. The elimination of capital gains taxes within the zones should stimulate investment in the zones by entrepreneurs and venture capitalists seeking to start and build up new businesses. It should attract new, small businesses to the zones with substantial growth potential. Fundamentally, this incentive will encourage capital improvements within the zone areas. This is necessary if these areas are to become desirable places to work and live and if jobs are to be created within them.

This tax treatment applies to any real or tangible personal property used in an Enterprise Zone in a trade or business. This includes such property utilized by existing businesses at the time a zone is designated. It does not include, however, idle property merely held for speculation, since it would not be used in a trade or business.

The capital gains elimination would also apply to ownership interests in Enterprise Zone firms. Entrepreneurs who start and build up new businesses would consequently be able to reap the full benefit of their labors when they sold out. Ownership of rental residential, commercial or industrial properties is treated as a trade or business for this purpose, allowing these properties to be sold without capital gains taxation. But the incentive does not apply to owner occupied residential properties, and these properties could, therefore, still be subject to such taxation. The incentive also does not apply to ownership interests owned by corporate entities. This will prevent abuses such as corporate parents transferring assets to their corporate subsidiaries in Enterprise Zones, merely so that these subsidiaries could then resell the assets and take advantage of the capital gains elimination. This incentive does apply, however, to all existing Enterprise Zone ventures which otherwise meet the necessary criteria.

These special capital gains provisions would continue to apply after a designated zone lapses until the first time each item of otherwise qualified property was sold. This would assure investors that they will be able to receive the benefit of this incentive and will avoid a rush to sell zone property when the end of the zone period approaches.

8. Industrial Development Bonds (Item 6). The provision of Industrial Development Bonds for small businesses in Enterprise Zones, regardless of whether the Administration eliminates the use of such bonds elsewhere, will help these businesses to obtain the necessary start-up capital to begin their ventures. These bonds must be approved by a state or local government when issued. The interest paid to the lender on the bond is then exempt from Federal income tax.

The inability to obtain start-up capital is the major complaint of those attempting to start new, small businesses. The availability of IDBs in Enterprise Zones should substantially ameliorate this problem.

9. The Operating Loss Carryover (Item 7). The provision extending the operating loss carryover will also help new and particularly small businesses. The carryover allows a firm making losses in one year to deduct those losses in future, profitable years. Under the 1981 Economic Recovery Tax Act, the carryover was extended for all firms to 15 years. The Enterprise Zone provision will allow firms in zones to deduct their losses made within a zone at any time during the life of a zone. Since the maximum period for Federal participation in a zone is 20 years, plus a four-year phase-out, this extends the carryover to up to 24 years. If a loss was incurred with less than 15 years remaining in the life of the zone, however, the normal 15 year carryover period would apply.

The credits available to an Enterprise Zone business could also be carried over during the life of the zone. If a zone firm has insufficient tax liability to take advantage of all of its zone credits in one year, it can deduct those credits against income tax liability in any future zone year.

New businesses generally suffer losses in their initial years, and it may be several more years before they have sufficient profits or tax liability against which to deduct these losses or their available tax credits. Extending the carryover period and allowing the zone credits to be carried over will, therefore, reduce the risk of starting a new business. This is particularly true for small businesses which usually do not have outside income against which to deduct their losses, as larger firms often have.

10. Foreign Trade Zones (Item 9). The final element in the tax package is the mandate for the creation of Foreign Trade Zones within Enterprise Zones. The statutory authority to create Foreign Trade Zones has existed since 1933 and many are currently in existence. Within these zones, the imposition of all duties and tariffs is delayed until the imported goods leave the zones for the domestic U.S. market. If the goods are used to manufacture other goods, the duty is exacted only on the value of the imported goods once the manufactured goods enter the U.S. market. If the manufactured goods are re-exported from the zone, then the duty on the imported goods is never levied. Foreign Trade Zones

are, therefore, excellent locations for warehousing imports or for manufacturing based on imported raw materials. Combining these incentives with the Enterprise Zone program will encourage the creation of such businesses within the zones.

11. The Overall Package. As a whole, the effect of the Federal tax package for most Enterprise Zone firms will be to eliminate 75 percent or more of the corporate income tax, eliminate entirely the capital gains tax, provide relief from tariffs and duties and provide easier access to start-up capital, as well as to provide income tax relief for the employees of such firms.

Overall, this tax package is deliberately skewed to encourage the creation of jobs for low-income and disadvantaged workers and to stimulate the establishment of labor-intensive business activities within the zones. A powerful credit is provided for hiring disadvantaged individuals. The annual wage caps on the general credits for zone wages for both the employer and the employee focus these credits more strongly on lower-income workers. Because of the strength of these labor credits in contrast to the capital credits, the entire package favors the encouragement of labor-intensive activities in general.

The package contains benefits for businesses already existing in an Enterprise Zone when designated. The capital gains elimination applies completely to such businesses. The investment tax credit applies to replacement investments by such firms and the credit for disadvantaged workers would apply to the hiring of replacement workers by such firms, if such workers were disadvantaged. The credit to the employer for zone payroll would apply to wage increases for existing workers for such firms as long as the salaries of these workers were below \$15,000 per year. The combined effect of these incentives is that an existing firm will receive an increasing tax reduction for its operations within an Enterprise Zone, as it displayed a continuing commitment to the zone, although the tax reduction would probably never be as great as it would be for an entirely new firm established after designation of the zone.

The main focus of the incentives is on the creation of new businesses or the expansion of existing ones. Businesses already in operation within an Enterprise Zone when designated would not receive credits for its past investments or for its established payroll expenses for previously hired employees.

### Federal Regulatory Relief

1. Importance of Regulatory Relief. In many ways, regulatory relief is the most promising of all the Enterprise Zone elements. Regulations impose enormous costs on businesses, discouraging economic activity and growth probably as much as taxes do. Regulatory relief, therefore, holds as much potential as tax relief for stimulating the revitalization of Enterprise Zone areas. Yet, removing these regulations where it is responsible to do so entails absolutely no monetary cost to the government, as does tax reduction. The case for boldness in regard to regulatory relief is, therefore, even greater than in regard to tax relief. Regulations should be relaxed or eliminated within the zones whenever they do not appear to be performing an important and necessary function.

In one significant respect regulatory relief is the obverse of tax relief--it should help small businesses more than large businesses. Large firms can generally absorb the costs of regulation more easily, by such means as spreading the costs imposed over more units of production, and are also better able to pass the imposed costs on to customers. Yet, small businesses do not avoid these costs by virtue of their marginal profitability, as is the case with many taxes. Regulatory relief is, therefore, particularly important for the stimulation of small businesses within Enterprise Zones.

2. The 1980 Regulatory Flexibility Act. The one Federal deregulatory element in the Kemp-Garcia bill is to bring zone businesses, zone-designating governments, and zone non-profit organizations, under the coverage of the 1980 Regulatory Flexibility Act. (See Appendix B). This act requires all Federal regulatory agencies to publish analyses of the economic impact on entities under its coverage of any proposed regulations and to discuss alternatives to those regulations. More significantly, the Act requires all Federal regulatory agencies to undertake a periodic review of all their regulations to determine whether they should be changed to minimize their economic impact on the entities under coverage of the Act.

This is a useful element to be included in the Enterprise Zone program. It will free agencies to focus on the impact of their regulations in Enterprise Zones and publicize this impact. But the Act does not appear to provide any authority for any substantive regulatory changes. It is not even clear that the Act empowers agencies to make different regulatory rules for the entities under the coverage of the Act. Something more is needed.

3. Regulatory Relief by Flexible Administrative Authority. Under the Administration plan, Federal regulatory bodies (all agencies covered by the Administrative Procedures Act) would be given discretionary authority to relax or eliminate their regulatory requirements within Enterprise Zones, in accordance with standards promulgated by Congress, but only upon the request of the state and local governments.

To utilize this authority, the state and local governments governing each zone would initially ask Federal regulatory bodies to relax or eliminate particular regulations within the zone. The Federal bodies would have the statutory power to grant such requests at their discretion. Congressionally mandated standards would dictate how the agencies were to use this discretion, requiring them to consider and avoid significant detrimental impacts on the public health, safety, welfare, etc. The standards would include an instruction to each body to weigh the special economic redevelopment purpose of the zones against the other important considerations and to relax or eliminate each particular regulation within a zone when appropriate. A Federal regulatory body would have no authority to take any action without a prior request from both the state and local governments governing each zone.

In many instances, Federal regulations are issued by agencies based on broad, general standards provided by Congress. These standards dictate to each agency the factors to be considered in issuing their regulations, and place bounds on the maximum and minimum degrees of regulation. The special Enterprise Zone authority would broaden these standards, requiring each agency to weigh heavily the need to stimulate economic redevelopment within Enterprise Zones. The authority would also empower these agencies to make special exceptions from their regulations for Enterprise Zones, and eliminate for such areas the minimum standard bounding the mandated regulated activity.

The special authority would also encompass regulations issued to interpret or carry out statutorily imposed requirements. While an agency would not be empowered to take actions contrary to the underlying statute, its discretion would be broadened to allow the agency to weigh the need to stimulate economic redevelopment within the zone areas. The agency would also have the power to make special exceptions from its regulations for Enterprise Zones.

The only regulations which would not be affected by this authority are those specifically imposed and spelled out by statute. The authority could be broadened to include such regulations if each such statute were expressly amended by the Enterprise Zone legislation. The Administration proposes that this be done in only one case.

This one case is the applicability of the minimum wage law to teenage employment within Enterprise Zones. Under the Administration plan, the Labor Department would be given discretionary authority to relax or eliminate the applicability of the law to such employment. The authority could be exercised only upon the request of both the state and local government governing each zone. The Department's discretion would also be delimited by Congressionally mandated standards, requiring the Department to weigh the public health, safety and welfare, and the economic well-being of workers, as well as the creation of jobs and economic activity within Enterprise Zones.

Teenage unemployment within the nation's depressed inner city areas, particularly among minority youth, has now reached the tragic proportions of 40 percent or even more. The minimum wage law is recognized as a strongly contributing factor to this problem. Employers will simply not hire low-skill workers when the value of their productivity in dollar terms is less than the mandated minimum wage. The law, therefore, in effect prevents such workers from being employed. Teenage workers are the most heavily affected by this since a high proportion of them lack the productive skills necessary to compensate an employer for paying the minimum wage.

The inability of an inner-city youth to obtain a job prevents him from ever developing the basic employment skills which will help him obtain better jobs in the future. It prevents such youths from ever getting on the economic ladder in the first place. It instead channels inner city teenagers into a downward spiral of unemployment, poverty and economic dependency.

## State and Local Government Role

1. Importance of the State and Local Role. The contributions to each zone by the state and local governments will probably make the difference in whether a zone succeeds or fails. There is a great deal the state and local governments can do, consistent with the Enterprise Zone philosophy, to enhance the likely success of the zones. Enterprise Zones do not represent merely a Federal initiative, but an effort by all levels of government to remove from the zones their nonessential impediments to economic activity.

Businessmen in particular have emphasized the value of the possible contributions to the zones at the state and local levels. Tax relief at these levels is important, but regulatory relief at these levels has been even more heavily emphasized. Businessmen have even suggested that state and local regulatory relief is far more important than Federal regulatory relief. The business community has also sought relief from inadequate, monopolized, local public services.

Leadership in mobilizing the local community and private sector to participate in the program is another crucial element which can be provided only at the state and local levels. Such efforts cannot be successfully undertaken by bureaucrats in far-away Washington unfamiliar with local conditions. These leadership efforts will in large part determine whether disadvantaged inner city residents will participate in the benefits of the program. They will also in large part determine whether the resources of the private sector will be as fully committed to the program as they could be.

2. Federal Flexibility. The initial importance of the state and local contributions is that they will determine what designated zones will be Federally approved. It should be emphasized that the Federal posture towards these contributions will be highly flexible. No particular element of tax relief or regulatory relief, or any other possible contribution, will be required. Failure to include one element in a state and local package of contributions could be offset by greater strength in the other elements.

It should be recalled, however, that the state and local contribution packages will be competitively evaluated against each other. Widespread willingness to include a particular element will, therefore, naturally provide pressure for all applicants to include it, or to enhance their packages further to compensate for its absence.

3. State and Local Tax Relief. A major concern expressed by state and local officials is that the Enterprise Zone program will force them to forego tax revenues just when they are already facing tight budgets and insufficient revenues. But, as just noted, the program will not mandate any particular state and local tax reduction. Moreover, the fiscal ability of the state or local government to provide tax relief will be considered in the competition for Federal approval. It will be recognized that, say, Houston, will be better able to grant tax relief to its zone than, say, Detroit. This principle also implies that state governments will be expected to make greater efforts at tax relief than city governments since the zone will represent a much smaller portion of the state's taxing jurisdiction than the city's.

It should also be recognized that the theory behind the program suggests that it may well be a net revenue generator for state and local governments rather than a revenue drain. Since there is little economic activity now in the zone areas, even if substantial tax relief is granted, little revenue will be lost. If the program is successful in generating new jobs and business activity within the zone areas, substantial additional revenues will be generated which could conceivably more than offset this loss.

A net revenue gain would be particularly likely at the city level. If city tax reductions for the zone were modest, the city would receive all the additional revenue generated by the strong Federal and state incentives, and its own non-tax incentives, at little cost. Stable property tax rates would in fact virtually assure a net revenue gain for the city. This is because property values within the zone are likely to rise due to the special incentives which apply there and the economic improvements which are likely to take place.

There are many possible elements of tax relief which state and local governments could contribute to the zones. Both governments could enact income tax relief, analogous to the Federal income tax relief, with the same likely effects. Relief from sales taxes could also be allowed within the zones. This would encourage the development of discount retail centers within the zone areas. Further economic development would stem from the large shopping crowds providing demand for other businesses, such as restaurants and recreation.

Another possible element is property tax relief. Such relief would encourage owners of land within the zones to develop it for industrial, commercial or residential uses, since the tax applied to the increase in value due to such development would not be as great. Property tax reduction should also help to preserve existing zone housing, since the squeeze of property taxes, rent controls and other urban costs has led many landlords to abandon buildings in inner city areas, resulting in burned out slums.

Numerous other taxes peculiar to various state and local jurisdictions could also be relaxed within the zones.

4. State and Local Regulation. As noted earlier, businessmen have emphasized the value of state and local regulatory relief to be contributed to the zones. Moreover, such regulatory relief will cost the state and local governments nothing. Such relief should, therefore, be a central element of any state and local incentive package. There is an almost endless array of state and local regulations which could be relaxed or eliminated within Enterprise Zones. A few are discussed below.

Zoning Laws. One web of entangling regulations which stifle economic activity stems from zoning laws. By restricting the uses to which property can be put, these laws often prevent businesses and other property owners from devoting their property to its most productive use. Many potential entrepreneurs may be prevented from going into business altogether because of restrictions on property they own or on other available property. The result is not only reduced property values, but inefficiency and misallocation of resources.

Moreover, within an Enterprise Zone, where substantial new but unknown economic activity is expected, the area should be opened up to a broad range of potential activities. Prejudging these activities by restrictive zoning regulations might forestall the potential boom altogether.

It is recognized, however, that zoning laws often are undertaken to preserve property values by prohibiting nuisance activities, for example. Also, zoning may be the best means for preserving housing areas within Enterprise Zones. The relaxation of zoning restrictions, rather than their elimination, may, therefore, be the preferred course of action by local officials.

Occupational Licensure Laws. These laws prohibit individuals from engaging in certain occupations unless they have a license from the government. These occupations include not only highly technical professions, such as law and medicine, but also a broad spectrum of more mundane endeavors.

While such restrictions on technical and critical services may seem justified, these restrictions are often extended unnecessarily into other areas merely to restrict competition. For example, in some jurisdictions licensing may apply to barbers, beauticians, real estate brokers and pool cleaners, to name just a few of the needlessly restricted occupations. Reducing the supply of providers in this way increases costs to consumers and unfairly raises the returns to established individuals in the field. It restricts the supply of jobs and reduces employment opportunities. These laws are particularly harsh on the poor and unemployed, who are thereby prevented from entering into many established occupations. In an Enterprise Zone, which is supposed to represent an area of unfettered opportunity, such laws should be abolished where they are not absolutely necessary.

Rent Control. Probably the most destructive of all state and local regulations is rent control. Such control tends to cause a shortage of housing by encouraging demand for scarce inner city dwelling space and discouraging supply. Even worse, the controls often prevent landlords from receiving adequate returns on their housing investments, inducing them to pull out their investments by letting their buildings deteriorate into slums and eventually abandoning them. The result is a perpetual housing shortage with ever growing slums engulfing the city.

Moreover, the rationale for rent control is specious. It is only fair that individuals pay the market value of their housing and landlords are entitled to receive the value of their services as much as anyone else. Such controls cannot be justified in the name of the poor, since the controls apply regardless of the income of the tenant. Even if rent controls could be limited to dwelling units rented to the poor, there would be no justification for requiring only landlords to bear the burden of helping the poor meet their housing costs. This is a burden which should be borne by all the non-poor in the society, not just landlords.

However, eliminating rent control for existing tenants could cause hardships. This would be avoided if rent control were permanently prohibited on any new dwelling units built within the zone and on all existing units as they became

vacant.

Usury Laws. A similar restriction is state and local limits on the interest which can be charged on loans. To the extent that such controls hold interest below market rates, they cause a shortage of credit by increasing the demand and reducing the supply. This shortage, however, may be felt only by the riskiest borrowers who would be charged the highest rates. An interest ceiling that kept the maximum rates below those that would otherwise be charged to these borrowers would in effect foreclose them from the credit market altogether. This can only make such borrowers worse off since they simply lose the opportunity to decide whether they want to borrow at the available rates.

Many of these riskiest borrowers may be small, inner city entrepreneurs. The effect of interest rate controls, then, is to prevent these entrepreneurs from obtaining the necessary capital to start their businesses. The elimination of usury laws within Enterprise Zones would increase the supply of capital to such zones and better enable entrepreneurs to obtain start-up capital.

State and Local Minimum Wage Laws. These laws have the same detrimental effect on the employment of the unskilled that the Federal minimum wage law does. If the Federal law is relaxed within the zones for teenage employment, then these laws should be relaxed as well.

Other Price Controls. All other forms of price controls, in addition to rent, interest and wage controls, have analogous negative effects. These controls should, therefore, also be primary targets for relaxation within the zones.

Permit Requirements. Entrepreneurs attempting to start new businesses are often faced with a myriad of permit requirements which must be satisfied before the business can begin. In addition to the sheer burden of complying with these requirements, businessmen are often faced with substantial delays because of poor administration of permit issuance. In some cases, denial of a permit will unnecessarily force a business establishment out of existence.

One way of addressing these problems would be to establish a one-stop shopping office for permits for Enterprise Zone businesses. Another alternative is to eliminate most or all of these requirements. An entrepreneur in an Enterprise Zone should not have to get the government's permission to start a business.

Central Planning Authorities. Inner city areas are also often under the jurisdiction of state and local boards, commissions, authorities or other entities which have the power to issue various economic development plans or planning regulations. These regulations restrict the range of economic activities which can occur in these areas and foreclose business opportunities. They run counter to the effort to create an open-market environment, which underlies the Enterprise Zone program. Removing the Enterprise Zone area from the jurisdiction of these entities would be a valuable state and local contribution to the program.

Building Codes. Yet another web of local regulations stem from building codes. These regulations, though well-intended, often impose heavy, unnecessary costs on businesses and developers, thwarting economic activity. The regulations in many cases are poorly suited to the particular circumstances of businesses or developers, who could achieve the same result through a cheaper, alternative method. The codes are also often outdated, requiring the use of outmoded and unnecessarily costly methods. Featherbedding requirements are also often included in the codes, again unnecessarily increasing costs.

Purging the codes of these drawbacks would be a beneficial contribution to Enterprise Zones. Another alternative is to impose liability on builders for defects in their buildings and require them to have insurance. Since the insurance company would have to pay for any defects, it would not issue insurance for unsafe buildings. Yet competition would force it to maintain the flexibility to adapt to the conditions of each builder and avoid the imposition of unnecessary costs.

Other Regulations. To reach many of the other state and local regulations which could be relaxed within Enterprise Zones, a general deregulatory authority could be created analogous to the Federal deregulatory authority. Each state and local regulatory body could be given discretionary authority to relax or eliminate their regulations within Enterprise Zones, to be exercised in accordance with legislatively mandated standards. These standards would instruct each body to weigh the need for job creation and economic development within the zone areas against the public health, safety, welfare, etc. and relax or eliminate its regulations within the zones when appropriate.

This would allow state and local governments to expand the regulatory relief within the zones over time, avoiding the need to catalogue every potential regulation to be affected from the beginning. It would also allow these governments to experiment with different combinations of regulatory relief within different zones, and to change these combinations over time.

5. Improved Local Services. One of the most important deterrents to economic activity in the inner city is inadequate or overly expensive city services. The inadequacy of these services may increase the cost of doing business in these areas, as businesses must do without or pay extra for supplemental services. Increased costs may also result from unnecessarily high taxes to pay for inefficient services. Inadequacy of city services may further reduce the returns to businesses in the area by reducing their appeal to consumers. The inadequacy of some services, such as crime protection, may make it simply impossible to do business in a potential Enterprise Zone area at all. In such cases, it is essential that some action be taken to remedy the problem if an Enterprise Zone is to be approved for the area.

Inadequate city services could be improved by the more traditional means of increasing the resources devoted to their provision. Increasing police patrols, providing additional funding for infrastructure maintenance, purchasing modern equipment, etc. could help to ameliorate the problem. The devotion of such increased resources to Enterprise Zones would be a favorable factor in the competitive Federal approval process.

But even greater improvements are likely to result from shifting reliance for the provision of these services to private sector firms and institutions, where feasible. One means of doing so is for local governments to contract with private firms to provide services formerly provided by municipal agencies. The contracts could be granted on a competitive basis to the private firm or institution which offered the best price and quality of service. A contract could cover the entire Enterprise Zone area, or only certain neighborhoods within the zone. The contracts could come up for renewal periodically so that the chosen contractor would be subject to continuing competitive pressures. This means of providing services is known as "contracting out," or "privatization."

A major advantage of this approach is that government monopoly is replaced by market competition. Consequently, incentives will operate to keep costs down and quality up. A government monopoly need not worry about costs or quality. If its customers think costs are too high or quality insufficient, they still must continue to pay through taxes and cannot take their business elsewhere. A private firm competing for city contracts, by contrast, must keep costs as low as possible and quality as high as possible to attract the needed customers to stay in business. Such firms must innovate and maintain efficient practices. As a result, through private contracting incentives are utilized to achieve better overall service.

Moreover, private firms can often achieve economies of specialization and scale not available to local governments. Competition also lessens the opportunity for corruption which often pervades entrenched government monopolies. Relying on private contractors will also allow local governments to evaluate their services more objectively and decide where funds could best be used, free from the political pressures of established bureaucracies.

Contracting with private firms to provide city services is more widespread than is commonly recognized. The Advisory Commission Intergovernmental Regulations (ACIR) has tabulated 66 services which are provided by cities contracting out with private firms. Experience indicates that such private contracting does indeed reduce cost and improve services. Cities have found that they can often reduce costs by 20 to 40 percent and improve services at the same time through this means.

Another means of utilizing alternative, private-sector providers is through associations or organizations of neighborhood residents, businesses or merchants. These associations could contract directly with private firms for the provision of services to their neighborhood areas, or they could provide such services themselves through self-help efforts. Once the provision of a service had been satisfactorily arranged through these means, the city could then cease serving the neighborhood area. To make such options feasible, however, two problems must be overcome.

The first is the problem of double payment. Residents of zones could hardly be expected to pay for services on their own if they have to continue to pay the city for such services through local taxes. Consequently, those who provide such services to themselves through neighborhood organizations should be allowed tax credits equal to the cost to the city of otherwise providing these services. For example, if a neighborhood association could save a city \$100,000 a year by doing their own refuse collection, the members of the association should receive a tax credit equal to this amount to divide among themselves. If the associations can actually provide the services more cheaply, then the neighborhood residents could make a profit and would have a strong incentive to undertake the provision of city services.

In some neighborhoods, the residents may not pay enough in local taxes to take full advantage of the tax credits. To solve this problem, the tax credits could be made transferable to any individuals inside or outside of the Enterprise Zone who made donations to neighborhood organizations for use in providing these services. If the zone residents could actually provide the services through these organizations at lower costs, then they could split some of the profits with the donor to give him an incentive to make the donation.

The second problem that must be solved is the free-rider problem. Some services normally provided by cities could not be denied to those who would not pay. Park maintenance and crime control are two examples. In these situations, at least some recalcitrant individuals may well refuse to pay their share of the cost of the service, since they will continue to enjoy it regardless of whether they pay. The cost of making up for these nonpayers is likely to make the service too expensive for remaining members of the association. It should be noted, however, that this would not be a problem for many typical city services for which nonpayers could be excluded from enjoying the benefits, such as garbage collection or transportation or education.

For those services where this would be a problem, the neighborhood association could solve it by inducing all neighborhood property owners to attach provisions to their deeds providing for automatic membership in the association for whomever owns the property. This would make all subject to the assessments of the association while allowing all to enjoy the benefits. Since such benefits are likely to be substantial due to the cost savings from alternative provision of city services, it should not be too difficult to induce virtually everyone in the neighborhood to join.

Once again, typical municipal services are performed by current neighborhood associations to a much wider extent than is popularly understood. Associations of homeowners most often perform these services in suburban developments. But there are also many examples of block associations of inner city residents performing such services. The Neighborhood Enterprise Association discussed in the next section would be an excellent vehicle for the provision of these services.

Local associations of residents are particularly well-suited to perform many city services on a self-help basis. Examples include day-care centers, care for the elderly, welfare services and crime-watch patrols.

Because local residents have a more intimate knowledge of their neighbor's needs, circumstances and abilities, these self-help efforts are particularly likely to be effective. Whether provided on a self-help or contracting out basis, however, utilizing alternative, private-sector, service providers through neighborhood associations should otherwise generally result in the same benefits as direct contracting out by the city as discussed above.

Still another method of utilizing private sector service providers is to grant tax credits directly to businesses who voluntarily undertake to provide certain services on a localized basis. These tax credits would have to be subject to case-by-case government approval to ensure that the services were useful and adequately provided. This mechanism would be particularly well-suited to the provision of infrastructure. A large corporation might rehabilitate the roads, or the water and sewage pipes, or the subway stations, in a rundown area, if it could obtain tax credits to reimburse it for doing so. The benefits to the local operations of the business would be the incentive for undertaking these activities. Similarly, a commercial or residential developer might provide such infrastructure to enhance its development.

The lack of adequate infrastructure in many inner city areas is another strong deterrent to inner city economic activity. Through these tax credits, efficient, private producers can be induced to provide much of this infrastructure at a lower cost than the city. To the extent that the city was going to build this infrastructure anyway, therefore, it could actually save money by relying on these tax credits.

A further means of developing private sector alternatives is to utilize user fees to finance current city services. Such fees would be charged to the beneficiaries of each service and should be sufficient to cover the cost of providing the service. Utilizing these fees would allow consumers to compare the cost of city services with private alternatives. If consumers could avoid the fees if they forego the services, then they could take advantage of superior private sector alternatives.

This would introduce market competition and incentives into the situation, with all the benefits noted above. Private firms would be induced to compete with the municipal agencies. Where they could successfully provide a superior service, consumers would choose them to replace the agency. This system would also provide an entirely new set of incentives to the municipal agencies themselves. They would now have an incentive to improve their efficiency and quality of service in order to maintain their existence.

Another privatization mechanism is known as "load shedding." This would involve simply stopping the provision of a service to an area where a private firm could be induced to take over the responsibility. Such load shedding would directly turn the service over to the private market. Ideally, where an area's taxes had previously been used to finance the service, a commensurate tax reduction should be allowed within the area so that businesses

and residents would not have an increase in expenses to finance the service. In some instances, however, a service may have been so inadequate that users had already begun utilizing private alternatives. In these instances, eliminating the service will simply save the city money.

A final mechanism for increasing private sector reliance is to encourage voluntary actions by private organizations, which is discussed in the next section.

All of these mechanisms are presented here simply as examples of actions local governments can take to improve services in Enterprise Zones. None of these actions are required for participation in the program. But these are actions which are consistent with the overall Enterprise Zone philosophy of removing government burdens and relying on the private sector, and which can substantially improve the attractiveness of an Enterprise Zone area. Credit will therefore be given in the competitive Federal approval process to state and local governments which will initiate experiments with some of these mechanisms in Enterprise Zones.

6. Local Community Involvement and Neighborhood Enterprise Associations. Another possible element of the contributions by state and local governments to the zones is for these governments to encourage participation in the program by neighborhood organizations and other private sector institutions. These would include churches, Community Development Corporations (CDCs), neighborhood associations, civic organizations, fraternal societies, recreational groups, country clubs, business associations, local political party units, unions and individual business firms, among others. There are many important roles in the program these institutions can serve.

One of the most important is to serve as conduits for participation by zone residents in the economic success of the zone areas. Churches and neighborhood organizations can, for example, create talent banks of available employees in the zones. Firms planning to start up in the zones could then inquire at these institutions for potential employees. Business associations or CDCs could provide job referral services, listing available jobs for zone residents seeking work. Business associations or individual firms could be induced to commit to providing a certain number of jobs for zone residents. Several of these community institutions could together establish basic job-training programs for those without fundamental skills. Voluntary contributions of time, space and other minor items could make the effort rather inexpensive. The more intimate knowledge these local groups would have of the needs and abilities of zone residents would greatly facilitate the successful administration of such a program.

This function could be further served by using these organizations to establish mechanisms for equity ownership by the zone residents in economic enterprises within the zones. An ideal institution for this role is the Neighborhood Enterprise Association to be discussed below.

One such mechanism would be for the state and local governments to transfer abandoned, unused properties to organizations of zone residents. These properties could then be leased to entrepreneurs who wished to establish businesses on them. As part of the rental price, the organization members

could even require a business to provide certain social services to the neighborhood, such as daycare centers, job training programs, or perhaps even jobs in the business for the residents themselves.

Another mechanism is to grant a tax credit to individuals who sell property to organizations composed of zone residents. The credit could exempt the sale from state and local taxes or be equal to a percentage of the property's value and deductible from the seller's other taxes. The credit would induce property owners to sell to such organizations at below market rates. These properties could then be used as above to obtain an ownership income for zone residents.

Still another mechanism is to provide for homesteading or shopsteading in zone areas. This would allow individuals to take over abandoned properties for nominal fees. If an individual resided on the property or operated a business there for a certain period of time, the individual would eventually become the outright owner of the property.

A final mechanism would be to encourage firms setting up in Enterprise Zones to offer opportunities for zone employees to gain ownership interests in the firm. Provisions already exist in the Internal Revenue Code to provide employers with an incentive to do this.

One result of these equity participation mechanisms would be to increase the income and/or assets of zone residents, who generally will be poor and disadvantaged individuals. But at least as important, these mechanisms would channel some of the benefits of the economic development of the zone to the zone residents themselves. This would be a key factor in preventing the zone program from simply displacing zone residents as the zone's economy improved. With their ownership interests, the zone residents would see their personal economic situations improve along with the improvement in the economic situation of the zone. These new interests would create a renewed commitment by the zone residents to the zone area.

A second role for these organizations is to serve as focal points for volunteer, self-help efforts by the zone residents and others. Neighborhood associations, for example, may establish citizen safety patrols, which would report suspicious or criminal activity to the police. Experience with these efforts indicates that they are often quite successful in reducing crime in a neighborhood area. Churches would be ideal for organizing volunteer day-care centers.

Other organizations could establish special recreational or educational activities for zone youths. These might include the creation of little league teams, scout groups and other, similar activities. Further self-help efforts might focus on the rehabilitation of local parks or buildings, or the collection of trash and garbage in the city streets. Business firms and individual business associations might be induced to donate funds to support local self-help efforts such as these.

The establishment of an Enterprise Zone in a city should draw the entire city's attention to the zone area. With local leadership, this attention can be used to stimulate volunteer efforts to aid the zone area, beyond what could usually be expected to occur. Moreover, with ownership interests and new job opportunities, zone residents should have a reinvigorated interest in efforts to improve the local community.

Still another role for these organizations is to rebuild community social structures and value systems. These organizations can express the local outrage over criminal and drug-related activity. They can apply social pressures to discourage such activity. These institutions can also organize the local social events that build a sense of community.

Finally, of course, these private sector institutions can serve as the organizations to take over the private provision of public services, where feasible and desirable, as described earlier.

As noted above, Neighborhood Enterprise Associations (NEAs), described below, would be ideal institutions for the performance of these functions. State and local governments could pass the legislation necessary to establish these institutions as part of their contributions to the zones. These institutions are described here because they were designed to be compatible with the Enterprise Zone program and could be expected to perform their assigned roles particularly well.

These Associations would be incorporated entities with zone residents as the shareholders. There would be one Association corporation for each neighborhood area. To start such an Association, residents would first define on their own the neighborhood area to which the Association would apply. The incorporating residents would also have to draft a charter and by-laws suitable for doing business in corporate form. The charter would authorize the corporation only to do business within an Enterprise Zone. Both the charter and by-laws would have to be amendable by 51% of voting stockholders. The incorporating residents would then have to notify all other residents of the neighborhood area to which the corporation applies and offer them free shareholder status.

All voting age residents who could prove at the time of incorporation that they had been residents of the corporation's neighborhood for at least one year would receive one equal share of Class A stock. Those who had been residents for less than a year would receive one equal share of Class B stock. New residents who moved into the area would also be entitled to one equal share of Class B stock, as would non-adult residents upon attaining voting age. The corporation would be under a continuing obligation to notify and offer these individuals their entitled stock interests.

Holders of Class A stock would each be entitled one vote in running the affairs of the corporation, including the distribution of profits. Holders of Class B stock would not be eligible to vote but would be entitled to attend and speak at shareholder meetings. Neither Class A stock or Class B stock would be transferable and each would revert back to the corporation upon the death of the holder. Class B stock, however, would mature into Class A

stock after seven years, if its owner had maintained continuous residence in the neighborhood for this entire time.

After the neighborhood residents had been notified and the stock had been distributed, the first shareholder's meeting for the corporation would be called. The voting stockholders at this meeting would then elect a board of directors from among their number. This board would then hire a professional chief executive officer to run the affairs of the corporation.

The corporation would not enjoy the advantages of NEA status until approved by a state agency, such as a Corporation Commission. The agency would grant this status only if the corporation complied with the procedures and major design features noted above. If the corporation failed to continue to fulfill the requirements, the agency would have the power to revoke NEA status.

State and local governments could grant these corporate NEAs several advantages to aid the zone residents in getting their business enterprises off the ground. The corporation could be made exempt from state and local taxes, in addition to qualifying for the Federal Enterprise Zone tax incentives. The state and local governments could also transfer or lease at nominal fees all unused government property in the neighborhood area of the corporation. A tax credit could also be granted to owners of real property in the neighborhood area of the corporation who sold their property to the corporation.

The NEAs could also be encouraged to take over the supply of some city services to the corporation's neighborhood. Transferable, local tax credits equal to the amount the city saves could then be granted to the resident members of the association. Tax credits could also be granted for donations to the corporation to aid volunteer, self-help activities.

This institution would provide a vehicle for all of the important roles noted above. The vehicle would also be in complete control of the zone residents. Local residents of the zones would be able to exert greater control over their local communities. For once, they would have the resources and the incentives to shape their communities into the kind of livable neighborhoods they desire.

State and local governments will, of course, not be required to include any of these elements in their Enterprise Zone programs. But a widespread consensus is developing in the business community, in the academic arena, and among those active in the field that such efforts are vital to successful inner city redevelopment. Consequently, the inclusion of at least some of these elements in a state and local zone contribution package will substantially aid the applicants in the competitive Federal approval process.

7. Other Factors. As noted in the Program Structure section, a number of other factors will also be important in the competitive Federal approval process. This section will discuss those factors in more detail.

One of these factors is the fiscal ability of the state or local governments to provide tax relief. It will be recognized that richer cities

will be better able to provide tax relief than poorer ones. Less tax reduction would, therefore, be expected from these poorer cities and greater credit will be given for the tax reduction efforts they do make. Moreover, greater tax reduction efforts will be expected from state governments than city governments. This is because the zone area would be a much smaller portion of the state's taxing jurisdiction than the city's and, therefore, the state will be better able to absorb the tax reduction.

Another factor is the degree of poverty and economic distress in the proposed Enterprise Zone. Poorer and more distressed areas will be given a priority over less economically weak areas. This factor, however, will not be determinative.

Additional factors determining which zones will be Federally approved will relate to the size and location of the zone. Zones will on average be expected to be 1 to 2 square miles. But larger zones of as much as 5 square miles would be acceptable in the larger cities though not too many zones this size would be approved. In smaller cities, zones of even one-half square mile might be suitable. The Secretary of HUD will have the power to deny approval to zones which are excessively large. The zones should also not be located in areas of heavy, existing, business activity, particularly including established plants of large companies. The purpose of the program is not to prop up existing companies, but to stimulate new ones. Allowing the zones to be located in areas of heavy, existing, business activity would substantially increase the cost of the program. The zones should also not be located in heavily residential areas with little room for the growth of business activity or even for new housing. The location of a zone in such an area could lead to substantial displacement of existing residents to other parts of the city. Gerrymandering a zone boundary to include existing businesses or stable, heavily residential areas will be viewed negatively in the Federal competition process. Gerrymandering a zone boundary to exclude such activities will, on the other hand, be encouraged.

Still another factor will be state and local incentives and contributions for the zones not discussed above. In particular, this would include the more traditional urban revitalization tools such as job training grants, infrastructure financing, loan programs, and other government expenditure efforts. In some cases, some of these more traditional tools will be necessary to revive an Enterprise Zone area, particularly in regard to infrastructure. In other cases, the state and/or local government may simply prefer these more traditional tools and should receive credit for the effort in the Federal competition. Greater credit will be given the more these expenditure programs are targeted solely to the Enterprise Zone area and if they are newly established after the zone designation. Little or no credit will be given for existing government expenditure programs which apply relatively uniformly state or city wide.

Another factor will be the extent to which effective and enforceable guarantees are provided concerning the promised state and local incentives and contributions. The most promising such guarantee would be to provide zone businesses, employees, or residents the right to sue in court (1) for enforcement of the promised incentives and contributions, and (2) for reimbursement for damages caused by any failure to maintain those incentives and contributions.

For some contributions, such as tax and regulatory relief, the continuation of the incentive and any damages caused by its weakening or elimination would be easy to prove. In other instances, involving, for example, commitments to improve municipally provided services, such proof will be more difficult. In the latter situation, further guarantee mechanisms may be necessary.

A further element would be legitimate commitments by investors to start or expand business activities in the zone. A zone application which could show a large number of investors ready to invest in the zone upon designation will have a natural advantage. This ties in with the last factor to be noted-- overall likely success of the zone. A zone which all things considered appeared to have a good chance of success will naturally be favored in the competition for Federal approval. This is a factor encouraging the designation of more marginal, less totally deteriorated areas, rather than the worst areas. This factor will have to be weighed along with the other, sometimes countervailing factors noted above.

The Secretary of HUD will also have the power to consider additional factors which in his opinion are consistent with the spirit of the Enterprise Zone program and which are necessary to minimize the unnecessary loss of tax revenues to the Federal Government.

#### Differences with the Kemp-Garcia Bill

The Administration plan is similar to the Kemp-Garcia bill, but contains a number of important improvements.

One of these is to strengthen the state role in the program. Under the Administration plan, the state government must affirmatively approve an Enterprise Zone designated by a local government before the Federal Government will consider the zone for Federal participation. Under the Kemp-Garcia bill, the Governor merely has 21 days to veto a local designation if the state disapproves. This change makes the program more consistent with the Administration's philosophy of Federalism. Also, under the Administration plan both the state and local governments must donate incentives and other contributions to the zone. Under Kemp-Garcia, only the designating government, which could be either state or local, must make contributions to the zone. This will ensure that zones in the Federal program will have contributions from all three levels of government.

A number of additional factors for consideration are also added to the competitive Federal approval process in the Administration plan. One of these is the emphasis on improvement of local services through the utilization of private sector providers (known as privatization), which is not included in the Kemp-Garcia bill. Involvement in the program by private sector neighborhood and community groups is more heavily emphasized in the Administration plan, although it is mentioned in Kemp-Garcia. State and local deregulation is also more heavily emphasized in the Administration plan. The Kemp-Garcia bill mentions only streamlining of regulatory procedures rather than substantive change in the regulation themselves. The Administration plan openly supports such substantive deregulation.

Further additional factors include: the location of the boundaries of the zone, the size of the zone, and the types of activities currently taking place within the zone; effective and enforceable guarantees by the state and local governments that their promised incentives and contributions will actually be carried out; legitimate commitments by investors to start or expand business activities in the zone; and the overall likely success of the zone. In addition, the Secretary of HUD is given the authority to add additional factors consistent with the Enterprise Zone concept and which are necessary to minimize the loss of tax revenues to the Federal Government.

The zones under the Administration plan will last for the periods designated by the state and local governments, but with a maximum of 20 years plus a four-year phaseout on the Federal participation. Under the Kemp-Garcia bill, Federally approved zones would last until the year 2002, allowing initially approved zones to continue for 20 years, but less than that for later approved zones. The Administration plan also provides for the creation of up to 25 zones in each of the first 3 years of the program. The Kemp-Garcia bill provides for the creation of 10 to 25 zones in each of the first three years of the program.

A major area of difference relates to the Federal deregulatory elements. As noted earlier, the Kemp-Garcia bill brings zone businesses, zone-designating governments, and zone non-profit organizations under the coverage of the 1980 Regulatory Flexibility Act (see p. 15). But because this Act appears to provide little if any authority for substantive regulatory relief, the general discretionary authority for Federal deregulation described above was added (see pp. 15-16).

A number of important differences also relate to the Federal tax incentive package for the program. One item in the Kemp-Garcia bill is the exclusion from taxable income of 50 percent of the income earned from an Enterprise Zone trade or business. This provision, however, suffers from intractable administrative difficulties relating to the problem of transfer pricing. Simply stated, a national corporation could routinely attribute much if not most of its national profits to Enterprise Zone subsidiaries, taking advantage of the zone tax reductions for non-zone activities. This could be done by selling the output of non-zone facilities to the zone subsidiary at or near cost, leaving the non-zone facilities with little if any profit. The zone subsidiary would then resell the output at market prices, in effect earning most if not all of the national corporation's profits. These profits would then be subject to the lower Enterprise Zone tax burdens.

To avoid this problem, the Administration plan relies on a tax credit approach tied to activities actually taking place in the zone. An investment tax credit is provided for capital investment in an Enterprise Zone and a payroll credit is provided for wages paid to a worker employed within an Enterprise Zone. These two credits replace the exclusion item in the Kemp-Garcia bill. This approach avoids the difficulty of determining where income was earned. But because the credits apply to the broad general categories of capital and labor expenses, which involve most of a firm's expenses, the ultimate effect is basically the same as with an income exclusion. A new, start-up firm will in effect naturally face lower marginal tax rates on its future income because of its regularly incurred capital and labor costs. Similarly, an expanding firm will in effect face lower marginal tax rates because of the capital

and labor costs it will naturally incur due to such expansion.

The Kemp-Garcia bill limited the extent to which this income exclusion applies to existing business activity by requiring that an existing business must increase its work force by 10 percent to qualify for the provision. But the Administration approach eliminates the need to define a qualified business at all. Any business could receive the tax credits, but only for its investment or its wages paid within the zone. The Administration plan, however, also limits the extent to which the tax reduction applies to existing businesses. The ITC does not apply to past investments, but does apply to replacement and net new investment after the zone is designated. The payroll credit does not apply to the total payroll of an existing business which was paid before designation. This means the credit does not apply to wages paid to existing or replacement workers. The credit applies only to payroll paid to net, additional workers. These limitations on the applicability of the tax incentives to existing businesses were imposed to avoid windfall gains to existing businesses and to reduce the cost of the program.

The Kemp-Garcia bill also provides that 40 percent of the new workers hired by an Enterprise Zone business must be CETA eligible for the business to qualify for most of the tax incentives in the bill. The motivation behind this provision is to ensure that the disadvantaged individuals in the zone area participate in the economic success of the zone. But this is an awfully blunt instrument for achieving that goal.

The most obvious problem with the requirement is that it substantially discourages investment in the zone by businesses which are not suitable to hiring such a large portion of CETA workers. These businesses, however, would probably stimulate spin-off and support businesses likely to be more suited to hiring CETA eligibles. They would contribute to a general climate of economic redevelopment and growth within the zones that would make it easier for other businesses to follow.

Moreover, if a business wanted merely to expand a portion of itself not suited to CETA-eligibles, it could not do so without hiring unnecessary CETA workers. A business could also lose the zone tax breaks through no fault of its own if some of its CETA workers quit. A number of administrative burdens and ambiguities also stem from this requirement.

The same goal of the requirement can be achieved, however, through a more flexible means. The Kemp-Garcia bill already includes a 5 percent credit to employees wages paid to CETA eligible workers. The Administration plan eliminates the hiring requirement but increases this credit to 50 percent of wages paid to disadvantaged workers in each of the first three years of the program, declining by 10 percentage points in each of the following years. (The definition of disadvantaged workers will be a revamped, updated version of the CETA definition). This allows firms not suited to hiring disadvantaged workers to still invest in Enterprise Zones, but it gives firms that can hire such workers every incentive to do so. It also removes many administrative difficulties and perverse incentives. This same approach is, in fact, taken by Congressman Charles Rangel (D-NY) in his Enterprise Zone bill (see Tab 2).

Another element in the Kemp-Garcia bill is a credit to zone employees for 5 percent of the wages earned in zone employment, with the credit applicable to

a maximum income of \$30,000 each year. This credit is available, however, only for the first three years of employment within the zone. Under the Administration plan, the credit is available for the entire zone period. But the maximum income to which the credit can apply is reduced to \$9,000. This is to focus the incentive more on low-income, disadvantaged workers.

The Kemp-Garcia bill make its credits against zone payroll for both the employer and the employee refundable. Refundability means, of course, that if the taxpayer's tax liability is less than the amount of the credit, the Government will pay him the difference in cash. This refundability feature was eliminated in the Administration plan, however, because it is more analogous to a direct Government subsidy than to a tax cut, and therefore is inconsistent with the Enterprise Zone concept.

Another Kemp-Garcia item would exclude from taxable income 50 percent of the interest received by a lender on a loan to an Enterprise Zone business. This item was eliminated in the Administration plan on the grounds that it would be too difficult to administer. The IRS, in auditing a bank, would also have to audit each of the borrowers who claimed that they had used the loan proceeds in their Enterprise Zone businesses. In place of this provision, the Administration plan includes a commitment to continue the availability of IRBs for small business within Enterprise Zones and to streamline IRB application procedures so that they can be regularly obtained. The interest on an IRB is entirely tax exempt.

An additional modified item in the Kemp-Garcia bill is the 10 percent tax credit for the construction or rehabilitation of low income rental housing within an Enterprise Zone. This was expanded in the Administration plan to apply to housing across the board, encouraging racially and socioeconomically integrated Enterprise Zone communities. It also was expanded to apply to commercial and industrial buildings.

Other changes in the Kemp-Garcia bill include the strengthening of the Foreign Trade Zone provision to order the Foreign Trade Zone board to establish such zones within Enterprise Zones when feasible, rather than to merely provide a sense of the Congress encouraging such designation. The Kemp-Garcia provision allowing small businesses to use cash accounting without inventories for tax purposes was eliminated on the grounds that it was administratively infeasible and would allow too much abuse. In addition, the elimination of capital gains taxes on ownership interests in Enterprise Zone firms is limited to noncorporate businesses engaged in active, rather than merely investment, business activities.

# Treasury Moves to Trim Some Tax Breaks Reagan Seeks for Depressed Urban Areas

By WALL STREET JOURNAL Staff Reporter

WASHINGTON—President Reagan has a few more decisions to make before unveiling his long-awaited plan to revitalize depressed areas as a result of a sudden change of heart by top Treasury officials.

Administration officials last week thought Treasury Secretary Donald Regan had agreed on the tax incentives to be incorporated into the President's "urban enterprise zones" program.

But five minutes before yesterday's session of the Cabinet Council on Commerce and Trade, Deputy Treasury Secretary R.T. McNamar introduced some proposals that were scaled down from those agreed upon earlier. The reversal by the Treasury outraged several other participants, including presidential special assistant Robert Carleson, and a heated discussion ensued.

As a result, the Treasury won the right to present certain of its tax proposals to the President as an optional package to tax incentives agreed to by the other members.

Treasury and other Cabinet representatives agreed on several tax incentives, including:

—A special tax credit of 3% to 10% allowed for capital investments in an enterprise zone by a qualified business. The credit would be in addition to the investment tax credit already available.

—Elimination of capital gains taxes on the sale of qualified property.

—Permission for a business in an enterprise zone to carry over its losses for tax purposes for as long as 20 years, an increase from the current limit of seven years in most cases.

Treasury officials differed on certain labor incentives. They don't want, as do the others, a tax credit for employers who hire certain disadvantaged workers. Such a credit would be 50% of covered wages in each of the first three years, and would drop 10 percentage points in each of the next four years.

The Treasury also favored reducing a proposed 10% tax credit for employers in an

enterprise zone to about 5.5%. Both options will go to the President. It is understood, in addition, participants other than the Treasury officials agreed to include an option that would permit a company that exhausts its income tax credits to begin deducting payroll tax credits.

The Cabinet group agreed on most non-tax issues relating to the zones. Under the plan the administration is likely to submit to Congress, as many as 25 areas would be designated each year for three years. Mr. Reagan is expected to make his final decisions this month.

Participants at yesterday's meeting included, besides Treasury, officials from the Department of Housing and Urban Development, which would oversee the program, and the Commerce Department.

THE WHITE HOUSE

WASHINGTON

CABINET COUNCIL ON COMMERCE AND TRADE

December 2, 1981

9:45 AM

Roosevelt Room

AGENDA

1. Enterprise Zones: Tax Policy (CM#42)

CABINET COUNCIL ON COMMERCE AND TRADE

PARTICIPANTS

December 2, 1981

The Vice President

Secretary Baldrige, Chairman Pro Tempore  
Secretary Block  
Secretary Donovan  
Secretary Pierce  
Secretary Edwards  
Chairman Weidenbaum  
Martin Anderson  
Dennis Kass, Executive Secretary

Deputy Secretary McNamar  
(Representing Secretary Regan)  
Deputy Secretary Trent  
(Representing Secretary Lewis)  
Ambassador Macdonald  
(Representing Ambassador Brock)  
Assistant Attorney General Baxter  
(Representing General Smith)

For Presentation:

Joe Wright, DOC  
Sherman Unger, DOC  
Gregory Ballantine, Treasury  
Steve Savas, HUD  
Peter Ferrara, HUD  
Bob Carleson

Jim Jenkins  
Jim Cicconi  
Annelise Anderson  
Kenneth Cribb, Jr.  
Mike Baroody  
Dan Smith

Ernest Johnston  
(Representing Secretary Haig)

THE WHITE HOUSE

WASHINGTON

CABINET COUNCIL ON COMMERCE AND TRADE

December 2, 1981

8:45 AM

Roosevelt Room

AGENDA

1. Enterprise Zones: Tax Policy/CM#42
2. U.S. Postal Service Electronic Mail Services/CM140

**CABINET AFFAIRS STAFFING MEMORANDUM**

DATE: 11/30/81 NUMBER: 050101CA DUE BY: -----

SUBJECT: CABINET COUNCIL ON COMMERCE AND TRADE -- December 2 Meeting

	ACTION	FYI		ACTION	FYI
ALL CABINET MEMBERS	<input type="checkbox"/>	<input type="checkbox"/>	<u>Baker</u>	<input checked="" type="checkbox"/>	<input type="checkbox"/>
Vice President	<input checked="" type="checkbox"/>	<input type="checkbox"/>	Deaver	<input type="checkbox"/>	<input type="checkbox"/>
State	<input checked="" type="checkbox"/>	<input type="checkbox"/>	Allen	<input checked="" type="checkbox"/>	<input type="checkbox"/>
Treasury	<input checked="" type="checkbox"/>	<input type="checkbox"/>	Anderson	<input checked="" type="checkbox"/>	<input type="checkbox"/>
Defense	<input type="checkbox"/>	<input checked="" type="checkbox"/>	Darman (For WH Staffing)	<input checked="" type="checkbox"/>	<input type="checkbox"/>
Attorney General	<input checked="" type="checkbox"/>	<input type="checkbox"/>	Jenkins	<input type="checkbox"/>	<input checked="" type="checkbox"/>
Interior	<input type="checkbox"/>	<input checked="" type="checkbox"/>	Gray	<input type="checkbox"/>	<input checked="" type="checkbox"/>
Agriculture	<input checked="" type="checkbox"/>	<input type="checkbox"/>	Beal	<input type="checkbox"/>	<input checked="" type="checkbox"/>
Commerce	<input checked="" type="checkbox"/>	<input type="checkbox"/>	<u>Allen Lenz</u>	<input checked="" type="checkbox"/>	<input type="checkbox"/>
Labor	<input checked="" type="checkbox"/>	<input type="checkbox"/>	<u>Annelise Anderson</u>	<input checked="" type="checkbox"/>	<input type="checkbox"/>
HHS	<input type="checkbox"/>	<input checked="" type="checkbox"/>	_____	<input type="checkbox"/>	<input type="checkbox"/>
HUD	<input type="checkbox"/>	<input checked="" type="checkbox"/>	_____	<input type="checkbox"/>	<input type="checkbox"/>
Transportation	<input checked="" type="checkbox"/>	<input type="checkbox"/>	_____	<input type="checkbox"/>	<input type="checkbox"/>
Energy	<input checked="" type="checkbox"/>	<input type="checkbox"/>	_____	<input type="checkbox"/>	<input type="checkbox"/>
Education	<input type="checkbox"/>	<input checked="" type="checkbox"/>	_____	<input type="checkbox"/>	<input type="checkbox"/>
Counsellor	<input checked="" type="checkbox"/>	<input type="checkbox"/>	_____	<input type="checkbox"/>	<input type="checkbox"/>
OMB	<input type="checkbox"/>	<input checked="" type="checkbox"/>	_____	<input type="checkbox"/>	<input type="checkbox"/>
CIA	<input type="checkbox"/>	<input checked="" type="checkbox"/>	_____	<input type="checkbox"/>	<input type="checkbox"/>
UN	<input type="checkbox"/>	<input checked="" type="checkbox"/>	_____	<input type="checkbox"/>	<input type="checkbox"/>
USTR	<input checked="" type="checkbox"/>	<input type="checkbox"/>	_____	<input type="checkbox"/>	<input type="checkbox"/>
CEA	<input checked="" type="checkbox"/>	<input type="checkbox"/>	CCNRE/Boggs	<input type="checkbox"/>	<input type="checkbox"/>
CEQ	<input type="checkbox"/>	<input type="checkbox"/>	CCHR/Carleson	<input type="checkbox"/>	<input type="checkbox"/>
OSTP	<input type="checkbox"/>	<input type="checkbox"/>	CCCT/Kass	<input checked="" type="checkbox"/>	<input type="checkbox"/>
_____	<input type="checkbox"/>	<input type="checkbox"/>	CCFA/McClaughry	<input type="checkbox"/>	<input type="checkbox"/>
_____	<input type="checkbox"/>	<input type="checkbox"/>	CCEA/Porter	<input type="checkbox"/>	<input type="checkbox"/>

Remarks: Attached are the agenda and background papers on Agenda item #1 for the Wednesday, December 2, meeting of the Cabinet Council on Commerce and Trade, scheduled for 8:45 AM in the Roosevelt Room.

A briefing paper on Agenda item #2 is forthcoming.

RETURN TO: Craig L. Fuller  
Assistant to the President  
for Cabinet Affairs  
456-2823

CONTACT: Kenneth Cribb, Jr.  
Assistant Director  
Office of Cabinet Affairs  
456-2800

## Cabinet Council Decision Memorandum

- I. Subject: Enterprise Zones
- II. Originator: Enterprise Zone Working Group
- III. Date: November 24, 1981
- IV. Issues: Non-Tax Aspects of Working Group Proposal

### Issue 1: Federal Deregulation

Analysis. The only provision for Federal regulatory relief in the Kemp-Garcia bill is to bring Enterprise Zone businesses, non-profit organizations and designating governments under the coverage of the 1980 Regulatory Flexibility Act. This Act, however, while acceptable for inclusion in the Enterprise Zone package, provides little if any authority for substantive regulatory relief, and a stronger provision is needed.

One way to provide additional relief is to grant Federal regulatory bodies (all agencies covered by the Administrative Procedures Act) discretionary authority to relax or eliminate their regulatory requirements within Enterprise Zones, in accordance with standards promulgated by Congress, and only upon the request of the state and local governments.

Under this approach, the state and local governments governing each zone would initially ask Federal regulatory bodies to relax or eliminate particular regulations within the zone. These bodies would have the statutory power to grant such requests, at their discretion. Congress would provide standards dictating how the bodies were to use this discretion. These standards would include an instruction to each body to weigh the special economic redevelopment purpose of the zones against other important considerations, such as the public health, safety and welfare, and to relax or eliminate each particular regulation within a zone when appropriate. A Federal regulatory body would have no authority to take any action without a prior request from both the state and local governments governing each zone.

An important advantage of this approach is that it avoids specifically designating any particular regulation for elimination and thereby stimulating opposition. Another advantage is that it greatly increases flexibility. Different types of regulatory relief could be tried out in different zones. Additional relief could be added over time if certain elements were initially overlooked. The relief could be changed over time in response to changing conditions. Yet such relief would never be provided where it didn't have the support of the local community.

This general power, however, could apply only to regulations issued at agency discretion. It could not apply to regulations specifically imposed by statute, such as the minimum wage law, without expressly mentioning each such statute in the Enterprise Zone legislation.

Regulatory relief from two particular statutory requirements has been considered by the Working Group. One is the Davis-Bacon Act, which requires the payment of the prevailing wage in the area on all construction projects paid for in whole or in part by direct, Federal funds. Eliminating the application of this provision to projects within Enterprise Zones would significantly lower the cost of providing new infrastructure in these areas.

Exemption of Enterprise Zones from Davis-Bacon could be sought outright or the Labor Department could be given discretionary authority as delimited above to relax or eliminate Davis-Bacon requirements if requested by the state and local governments. The inclusion of either provision, however, would lead to opposition by organized labor. Moreover, relaxation of Davis-Bacon requirements nationwide is already being pursued by the Administration.

The second statutory requirement considered is the minimum wage law. This law is widely considered to increase unemployment among the unskilled by setting the minimum wage above their productivity level, making it unprofitable for any employer to hire them. Unemployment among one group of the unskilled, namely, inner city minority youth, is at an extremely high level.

One way to approach this problem would be to grant the Labor Department discretionary authority as delimited above to relax or eliminate the minimum wage within Enterprise Zones when requested by the state and local governments. Another alternative is to grant the Labor Department this power, but limited only to teenage employment within Enterprise Zones. Still another possibility is to exempt teenage employment within the zones outright by statute. Any of these alternatives will arouse labor opposition to Enterprise Zones.

Recommendations. The Working Group recommends that

- o the general discretionary authority for Federal regulations within Enterprise Zones described above be adopted,
- o relaxation of Davis-Bacon Act requirements not be included in any Administration Enterprise Zone initiative
- o the Labor Department be given the discretionary authority as described above to relax or eliminate the minimum wage only for teenage employment within Enterprise Zones and only upon request of the state and local governments.

Decision

Accept       Reject       Accept as amended   
 No Action

## Issue 2: State and Local Deregulation

Analysis. Under both the Kemp-Garcia bill and the Working Group approach, state and local governments would compete for Federal participation in their designated Enterprise Zones. The Federal Government would generally choose for participation those zones whose state and local governments had done the most to responsibly remove government burdens on economic activity within the zone area. In listing the criteria by which this competitive process is to be governed, however, the Kemp-Garcia bill does not explicitly endorse deregulation within the zones by state and local governments. Instead, it speaks vaguely of "streamlining" and "simplification" of regulations.

Deregulation at the state and local levels can be extremely important in stimulating the economic redevelopment of Enterprise Zone areas, particularly for small businesses--which are the principal job generators. Moreover, such deregulation is the one incentive state and local governments can provide without incurring any monetary costs.

Recommendation. Preference in the competitive Federal approval process should be given to those Enterprise Zones where the state and local governments contribute substantive, responsible, deregulation.

### Decision

Accept       Reject       Accept as amended   
 No Action

## Issue 3: Other Federal Programs

Analysis. Other Federal programs aimed at urban economic development may still be in effect when Enterprise Zones come into being. These programs generally involve grants, loans, loan guarantees and tax exempt financing. An important issue is what relation these other programs should have to Enterprise Zones.

One alternative is to prohibit the use of any of these programs within Enterprise Zones on ideological grounds.

A second alternative is to permit the use of these other programs within Enterprise Zones. Some of these programs provide funding for infrastructure and for front-end capital for small businesses, which is not available through the Enterprise Zone program and which many contend is necessary. Since these programs are available, it may be argued that there is no good reason why they should not be used in Enterprise Zones as well as anywhere else.

A third alternative is to encourage the use of these programs in Enterprise Zones, perhaps through set-asides. Many argue, however, that

this would violate the basic concept underlying the program. Moreover, set-asides would increase pressure from the remaining constituents of these programs to increase funding, contrary to recent budgetary efforts.

Recommendation. We should permit the use of other, existing Federal government programs within Enterprise Zones, but oppose the creation of set-asides for Enterprise Zones in these programs or the creation of other federal spending programs to be used in Enterprise Zones.

*Mac: if Ent Zones are to work, they may need add'l help.  
why include?  
budget sit. will preclude.*

*will not forbid: positive*

Decision

Accept \_\_\_\_\_ Reject \_\_\_\_\_ Accept as amended \_\_\_\_\_

No Action \_\_\_\_\_

Issue 4: Size of the Program

Analysis. The Kemp-Garcia bill provides for a minimum of 10 and a maximum of 25 zones in each of the first three years of the program. Early drafts of the Kemp-Garcia bill called for a minimum of 25 zones to be designated in each of four years, with no maximum limit. Based on instructions from the Cabinet Council earlier this year, the Working Group negotiated with the bill's sponsors to obtain the minimum and maximum limits currently in the bill. The sponsors of the bill, therefore, feel there is now some Administration commitment to support this range. The sponsors have stated that they will oppose efforts to turn Enterprise Zones into a token program. An effort to reduce these numbers further could well backfire and result in higher minimum and maximum limits.

*Key point of Kemp.*

Because of possible difficulties in starting up the program, however, the minimum limit may be too constraining. Eliminating this minimum will also increase Administration flexibility to make adjustments in the program as fiscally necessary.

*Pierce: statement of caution*

Recommendation. Basically retain the Kemp-Garcia scale for the program, with authority to designate up to 25 zones for each of the first three years of the program, and no authority to designate any additional zones after that.

Decision

Accept \_\_\_\_\_ Reject \_\_\_\_\_ Accept as amended

No Action \_\_\_\_\_

Issue 5: Urban Focus

Analysis. In a meeting earlier this year, the Cabinet Council expressed the view that Enterprise Zones should be located in large, urban areas, at least in the initial years of the program. A bill that excludes rural areas

by definition, however, will be politically quite difficult to pass through Congress. It has been widely suggested that, faced with such a proposal, Congress is likely to establish a set-aside in the program for rural areas.

One way of avoiding this problem is to allow rural areas to qualify under the bill's criteria for Enterprise Zone eligibility. Zones designated in these areas by state and local governments would be able to compete for Federal participation. But the Federal government would use its discretion in the competitive process to designate zones primarily in large urban areas, though at least some zones in rural areas would have to be chosen.

The intended preference for urban areas in this process would be made part of the legislative history of the bill and advertised in the administration of the program, to avoid political difficulties in carrying out. This is the approach taken by the Kemp-Garcia bill and it has been assumed that the Cabinet Council favored it as well.

Another approach is simply to exclude rural areas from qualifying under the bill's eligibility criteria and face the political difficulties.

Recommendation. Allow rural areas to qualify and compete for Federal participation in their designated Enterprise Zones, and rely on Federal discretion to focus the program on large, urban areas, adopting the Kemp-Garcia approach.

Decision

Accept  *but positive*      Reject       Accept as amended   
 No Action

Issue 6: HUD Administration

Analysis and Recommendation. HUD should be the lead agency in pursuing adoption of the program and should be charged with administering the program, as in the Kemp-Garcia bill.

Decision

Accept       Reject       Accept as amended   
 No Action

↘ *Treas. objects; bulk is tax program.*

Block: *HUD should not administer in rural areas*

Cabinet Council Decision Memorandum

- I. Subject: Enterprise Zones
- II. Originator: Enterprise Zone Working Group
- III. Date: November 24, 1981
- IV. Issue: Federal Tax Package

Analysis. The Working Group has developed the following package of Federal tax incentives for the Enterprise Zone program:

1. A special investment tax credit would be allowed for capital investments in an Enterprise Zone. For differing classes of machinery and equipment, this credit would be 3 to 5 percent. For the construction or rehabilitation of commercial, industrial and rental housing structures within the zone, the credit would be 10 percent.
2. Capital gains taxes on the sale of zone property (qualified property as defined below) would be eliminated.
3. Employers would be allowed a 10 percent nonrefundable income tax credit for payroll paid to zone employees (qualified employees as defined below) in excess of payroll paid to such employees in the year prior to designation of the zone, with the credit calculated against a maximum of 2.5 times the FUTA wage base for each worker (currently 15,000, leaving a maximum credit of \$1,500 per worker).
4. Employers would be allowed a nonrefundable income tax credit for wages paid to zone employees (qualified employees as defined below) who were also disadvantaged workers (to be defined based on the CETA definition) when hired. The credit would be equal to 50 percent of such wages in the first three years of employment, declining by 10 percentage points in each year after that.
5. Zone employees (qualified employees as defined below) would be allowed a 5 percent nonrefundable income tax credit for taxable income earned in zone employment, with the credit taken against a maximum taxable income equal to 1.5 times the FUTA wage base (currently 9,000, leaving a maximum credit of \$450 per worker).
6. Any Enterprise Zone firm would be allowed an operating loss carryover for the life of the zone in which it is located, or 15 years, whichever is less.

7. The Foreign Trade Zone Board would be instructed that, whenever possible, Foreign Trade Zones should be established within Enterprise Zones and applications of such Enterprise Zones to become Foreign Trade Zones should be expedited and given special consideration.
8. Industrial Development Bonds (IDBs) could be issued to provide loans to small businesses located within Enterprise Zones, even if the Administration terminates the use of IDBs elsewhere.
9. Definitions--
  - (a) Qualified property is
    - (1) any real or tangible personal property which was used predominantly by the taxpayer in an Enterprise Zone in the active conduct of a trade or business, and
    - (2) any interest in a corporation, partnership, or other entity if, for the most recent taxable year of such entity ending before the date of the sale or exchange, such entity was
      - (i) engaged in the active conduct of a trade or business within an Enterprise Zone and
      - (ii) with at least 50 percent of its employees performing substantially all of their services for the business within the zone.
  - (b) A qualified employee is any employee who performs more than 50 percent of his services within an Enterprise Zone.
  - (c) Ownership of rental property, whether residential, commercial or industrial, within an Enterprise Zone shall be treated as the active conduct of a trade or business.
  - (d) The treatment of property as qualified property for purposes of the capital gains provisions shall not be terminated at the end of the period for which the Enterprise Zone in which the property is located or used is in effect, but shall terminate after the first sale or exchange of such property occurring after such period.

The Treasury estimates that this tax package, with 10-25 zones, will result in a revenue loss of 91-227 million in the first year of the program-- fiscal 1984, assuming no change in activity (see attachment). This loss would increase commensurately in the following fiscal years for additional numbers of zones. Legislative constraints will be placed on the size of the zones to ensure that this cost will not be substantially increased through the designation of excessively large zones.

The Working Group believes that this package provides substantial incentives for the creation of jobs and the stimulation of business activities within Enterprise Zone areas. Taken in conjunction with the other elements of the program at the Federal, state and local levels, the Working Group believes that adoption of this package will result in a successful program.

Overall, this tax package is deliberately skewed to encourage the creation of jobs for low income and disadvantaged workers and to stimulate the establishment of labor intensive business activities within the zones. A powerful credit is provided for hiring disadvantaged individuals. The cap on the wage base for the general payroll credit will further encourage the hiring of low income workers. The wage base cap on the credit for zone employees also focuses this incentive more strongly on low income workers. Because of the strength of these labor credits in contrast to the capital credits, the entire package favors the encouragement of labor intensive activities in general.

Recommendation. It is recommended that the Cabinet Council adopt the above Federal tax package developed by the Working Group for the Enterprise Zone program.

Decision

Accept \_\_\_\_\_      Reject \_\_\_\_\_      Accept as amended \_\_\_\_\_  
No Action \_\_\_\_\_

Attachment

Estimated Tax Revenue Loss\*

	FY'84	FY'85	FY'86
First 10-25 zones	91-227 million 124-310 million	91-227 million 124-310 million	91-227 million 124-310 million
Second 10-25 zones	-- --	91-227 million 124-310 million	91-227 million 124-310 million
Third 10-25 zones	-- --	-- --	91-227 million 124-310 million
Total Cost of Program	91-227 million 124-310 million	182-454 million 248-620 million	273-681 million 372-930 million

\*The top figure in each box is based on the assumption that the program results in no change in activity in the zones; the bottom figure is based on the assumption that economic activity in the zones increases by 10 percent, primarily through relocation and substitution of economic activity that would have occurred elsewhere.

These estimates were based on a hypothetical zone in the city of Chicago and would be different to the extent that the characteristics of that zone were atypical.

Proposed Amendments to the Enterprise Zone Tax Package

The most recent draft of the Cabinet Council Decision Memorandum on Enterprise Zones [November 20, 1981] outlines eight tax provisions. Several of these provisions would present serious administrative problems, which could be avoided by restructuring. Others need clarification, and one (the first one) requires a choice of levels.

Listed below are the components of the working group's Enterprise Zone tax package and a recommendation for the Treasury position.

1. Proposal: A special investment tax credit would be allowed for capital investments in an Enterprise Zone. For differing classes of machinery and equipment, this credit would be 0 to 5 percent. For the construction or rehabilitation of commercial, industrial and rental housing structures within the zone, the credit would be 10 percent.

Recommendation: The investment credit should be 10 percent on structures and an additional 10 percent rehabilitation credit. The extra credit on equipment should be kept below 5 percent, preferably there should be no extra credit on equipment.

2. Proposal: Capital gains taxes on the sale of zone property would be eliminated.

Recommendation: The capital gains exclusion should be limited to capital gains attributable to the real property and the qualifying tangible personal property used in the zone business. Proceeds attributable to other assets of the business, such as securities, patents, good will, or assets not located in the zone, should not qualify for the exclusion.

3. Proposal: Employers would be allowed a 10 percent nonrefundable income tax credit for payroll paid to zone employees in excess of payroll paid to such employees in the year prior to designation of the zone, with the credit calculated against a maximum of 2.5 times the FUTA wage base for each worker (currently 15,000, leaving a maximum credit of \$1,500 per worker).

Recommendation: A 15 percent credit should be applied to increases in the FUTA wage base. For new firms, 25 percent of FUTA payroll would be eligible for the credit.

4. Proposal: Employers would be allowed a nonrefundable income tax credit for wages paid to zone employees who were also disadvantaged workers (to be defined based on the CETA definition) when hired. The credit would be equal to 50 percent of such wages in the first three years of employment, declining by 10 percentage points in each year after that.

Recommendation: The Targeted Jobs Tax Credit scheduled to be ended in 1983 should be extended in Enterprise Zones. The limit on qualified wages to be set at either \$6,000 or \$8,000.

5. Proposal: Zone employees would be allowed a 5 percent nonrefundable income tax credit for taxable income earned in zone employment, with the credit taken against a maximum taxable income equal to 1.5 times the FUTA wage base (currently 9,000, leaving a maximum credit of \$450 per worker).

Recommendation: We have no recommendation.

6. Proposal: Any Enterprise Zone firm would be allowed an operating loss carryover for the life of the zone in which it is located, or 15 years, whichever is longer.

Recommendation: This provision is acceptable.

7. Proposal: The Foreign Trade Zone Board would be instructed that, whenever possible, Foreign Trade Zones should be established within Enterprise Zones and applications of such Enterprise Zones to become Foreign Trade Zones should be expedited and given special consideration.

Recommendation: This provision is acceptable.

8. Proposal: Industrial Development Bonds (IDB's) could be issued to provide loans to small businesses (to be defined) located within Enterprise Zones, even if the Administration terminates the use of IDB's elsewhere.

Recommendation: It should be accepted with a definition of small business related to the size of the company's total resources.

ROBERT J. DOLE, KANS., CHAIRMAN

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*BRK/ASE / EM-MA*

*We need to consult with*

United States Senate

COMMITTEE ON FINANCE  
WASHINGTON, D.C. 20510

*Dole on this*

*before*

*State of*

*Union*

*Proceed with Carter*

January 8, 1982

TO: Jim Baker

FROM: Bob Dole

I understand from various reports that the President has given preliminary approval to an urban development initiative involving the establishment of 'enterprise zones,' and that this initiative might be a major point in the State of the Union address.

Before the administration proceeds with this plan, I would like to share some concerns we have on the Hill. As the administration proposal has been described in the press, it would involve mainly targeted tax relief measures. As such, it is of obvious interest to the members of the Finance Committee.

Clearly the enterprise zone concept is an interesting and innovative approach to the problem of urban blight, but the original concept has been changed considerably in the proposals that are circulating in Congress and within the administration. The focus now is on various forms of targeted tax relief, with the targeting done to certain geographic areas, rather than to certain classes of taxpayers. I understand that the President has made a commitment to pursue this option, but the White House might want to review some of the drawbacks to the targeted tax relief approach. Specifically:

- One of the goals is to encourage businesses to locate, or new businesses to develop, within the zones. There is strong evidence that incremental tax advantages are not a significant factor in locational decisions for most business. This is even more likely to be true in light of the broad-scale tax relief we enacted in 1981.

- Most of the proposals under discussion involve a wage subsidy to employers within an enterprise zone, in the form of an employment tax credit. Our experience with such credits has not been a great success. Just this year we agreed--with administration support--to tighten up significantly the Targeted Jobs Tax Credit, which was intended to attack hard-core unemployment but proved to be little more than a corporate subsidy.

*f. Enterprise zones*

- There is a risk that tax incentives to attract business to a zone could provide opportunities for sheltering and abuse: for instance, to avoid taxes due on income generated outside of the zone. Lines may be difficult to draw to avoid this, and the cost of adequate oversight could be considerable. It could hurt the administration if its urban development initiative were seen as just another boon to big business.

- The problem of start-up capital--which is most important to generating new business activity, as opposed to shifting around existing activity--may not have been adequately addressed by the proposals.

- The administration has persuasively argued over the past year that economic incentives ought to be broad-based and of general applicability. That may be difficult to square with a proposal for narrowly-targeted tax subsidies.

Clearly there is much that is appealing in the enterprise zone idea, including the notion of experimenting with dramatic forms of regulatory relief, which no longer seems to be such an important factor in the proposals under consideration. But I hope you will take these points into consideration in deciding whether to start out with a major presidential initiative, rather than with an exploration of alternatives in consultation with Congress to develop a workable and saleable plan.