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Take Care of Business

By Anthony Randazzo

INTRODUCTION

The Internet and globalization have both made it possible to operate a business from virtually anywhere, serving a wide range of customers. Most firms no longer need to be located in downtowns or large financial districts. This flexibility has made it possible for businesses to leave cities that have an unfavorable tax and regulation climate. As a result, once great American cities have been experiencing job and revenue losses over the past few decades as businesses—large and small—have relocated to areas that are less restrictive on their growth and development.

Fifty years ago, workers were flocking from rural southern towns to the growing industrial cities in the north. Detroit grew rapidly as a center for the automotive and music industries. Buffalo was an indispensible artery for growth because of its trading capacity with its rail lines and ports. Cleveland was a capital for oil during the expansion of Standard Oil, and later iron and steel production. But as time wore on, these industries began to give way to telecommunications, information technology and the service industry.

Faced with declining profits and harsh regulatory climates, auto, oil and steel companies began moving south where costs of labor and property taxes were lower. As transportation usage shifted toward less expensive and less time-consuming modes, such as air and automobile, rail-dependent towns with unattractive laws governing entrepreneurism were left out in the cold.

Once great American cities like Detroit, Cleveland, Pittsburgh, Baltimore and Cincinnati are now shells of their former glory. Cities are faced with 21st century challenges that fundamentally question the logic of existing economic development policy. Many of the American cities in decline have failed to notice how the economy continuously repositions itself in an information-driven, globally competitive world market, and have failed to respond with policies that encourage entrepreneurial investment, private sector growth and local consumption of goods, services and housing.

The Role of Government In Business Development

The vast majority of new jobs come from local small businesses that expand and diversify over time. Designing conditions for entrepreneurship to thrive is paramount for building vibrant and robust economic growth. This means competitive tax—business, sales and property—policies. This means a regulatory and licensing structure that does not discourage new businesses, expansions or renovations. Nothing will drive businesses away faster than nightmarish red tape and profit margins devastated by excessive taxation.

In the late 20th century, many elected officials believed that government could create jobs by investing directly in projects, or by providing initial funding for projects that would create a catalyst for long-term investment and growth. Most of these plans have achieved results far below expectations, as government subsidies typically fail to produce long-term growth.[1] Public works projects may provide a short-term infusion of cash that increases the number of jobs in the short run but they don't provide a foundation for sustained investment. In the end, private investment is best at creating sustainable economies. Oftentimes this means local policymakers allow for organic business development, instead of trying to handcraft economic stability.

Local officials rarely can pick and choose among those private businesses to determine which will be successful. Wealth creation, from a public official's perspective, is largely a spontaneous process where the logic and rationale of the success of a particular business can be determined only in retrospect.

While economic growth is more vibrant in cities that have less restrictive entrepreneurial policies, this does not mean there is no role for government in promoting business development. The efficient provision of core services is paramount to long-term success. Local governments are able to provide certain services and products that no one else can—or will—provide. These core competencies include local infrastructure, law enforcement, a justice system and other services. Local governments should focus on providing these services to avoid compromising economic development in the short and long run.

Infrastructure: It is impossible for cities to function without well-managed systems for moving goods, people and ideas. Transportation systems allow people to get to work, supplies to be delivered and customers to shop. Communications infrastructure, like telephone and cable connections, allows businesses to leverage the power of the Internet, phones and other means to transport ideas and connect with clients. When entrepreneurs consider whether a city offers appropriate opportunities for them, transportation and digital infrastructure are key components they look at.

Law Enforcement: People typically prefer to live in safe locations. There is often a direct correlation between crime rates and property values. As a result, cities that offer better law enforcement are more likely to attract businesses that will be successful in the modern economy. High crime rates are also likely to drive out business owners and customers.

No Silver Bullets

Local economic growth depends on the success of the business community, and private sector participation is the general key for promoting that success. Over the past two decades, economic development specialists have recognized that good projects almost always have a significant private sector component because entrepreneurs have a better grasp of market conditions and the long-term viability of certain kinds of projects. In short, the private sector does a better job of leading and managing projects and leveraging public dollars than does the public sector investing on its own.

However, there are no silver bullets for generating private sector growth in local economies. Instead, there are basic principles that city officials can approach on a step-by-step basis. These steps involve ensuring the tax code doesn't drive businesses away, and relaxing regulations and red tape that are a deterrent for new businesses to open up.

TAXES AND FEES

The city of Houston is a great place to do business, according to many, including the Chamber of Commerce in Barcelona, Spain. In 2009, a new manufacturing plant opened in Houston called B-Ventura, owned by Jordi Blanche whose company is based in Barcelona. While B-Ventura could have opened anywhere, it chose Houston partly because there is no local or state income tax.

Businessman Dan Bellow, chairman of the Greater Houston Partnership says of Houston, "A majority of the employment base comes from small businesses, people who employ less than 100 people. And, you know, those are the people who you need to support. You need to make it easy for them to do business. You need to make it affordable, from a tax point of view."

In contrast to thriving Houston, the city of Cleveland is in decline, in large part to its growing tax burden. Residents not only pay federal and state taxes, but also are burdened with a local income tax, local sales taxes, property taxes and payroll taxes. It is not the kind of simple, limited tax structure that encourages business development. Local leaders should be aware of how various taxes can weigh down economic growth.

Business Taxes

The higher the business tax burden—whether through income taxes on the self-employed, corporate taxes or others—the less likely a small business is to open in a city, or remain in a city. It is not surprising that the two states with the highest combined stated and local tax burdens, New Jersey (11.8 percent) and New York (11.7 percent), have some of the lowest self-employment rates in the country, 5.6 percent and 5 percent respectively. A 2008 report from Ewing Marion Kauffman Foundation, Entrepreneurship and Urban Success: Toward a Policy Consensus, finds:

While higher business taxes tend to make entrepreneurship less attractive, lower business taxes make it more appealing. It may be that Florida's relatively low business tax rate (5.5 percent) is one of the reasons that self-employment is so high in that state. This fact suggests that keeping business taxes low relative to standard income taxes will be helpful in supporting entrepreneurship.

Business taxes, in addition to creating disincentives to start business, place a higher tax burden on low-income individuals, as the tax is often passed on to the consumer.

It should be noted, however, that some cities are so highly concentrated with consumers that the business potential outweighs the increased tax rates. Policymakers have to weigh the effect taxes have on business and be aware of the potential negative consequences of high taxes.

Local Sales Taxes

Just as business taxes are likely to discourage businesses from setting up shop in cities, local sales taxes are likely to discourage consumption from citizens. With states already collecting sales taxes, an additional local sales tax can put a municipality at a competitive disadvantage. Since every business in the state has to charge the same sales tax rates, they are all on equal footing in their industries. But if a city or county charges an additional sales tax on top of that rate it can drive consumers and businesses to less oppressive markets.

Local sales taxes designed to increase revenues can also be unfairly levied on one constituency for the benefit of all. Alcohol and other "sin taxes"—such as junk food, transfats and cigarettes—are often the target of city leaders trying to raise revenues. But not only do targeted sales taxes, sin tax or not, create a disincentive for businesses to open up in that industry, they unfairly burden one sector of society.

In 2007, Allegheny County, Pennsylvania, home to the once great steel town Pittsburgh, passed a 10 percent sales tax on all poured alcoholic drinks. The tax was first conceived after the Pittsburgh-area public transportation budget ran out of money. However, the sales tax on alcohol had no direct correlation to public transportation. Why not increase taxes on books, hamburgers, or Pittsburgh Penguin paraphernalia? They are just as arbitrary as linking alcohol taxes to public transportation. Why do only consumers of alcohol need to pay for a broken transportation system?

These kinds of taxes certainly have the potential to deter consumption. People in the Pittsburgh area can potentially go to a bar outside the Allegheny County limits, removing any tax revenue from that customer. Some may limit the drinks they purchase because of the increased price. Some may limit their purchases because of the psychological effect such a targeted tax might have. These taxes could potentially drive citizens out of the municipality all together, if the onerous tax is frustrating enough.

These types of sales taxes also create headaches for business-owners. Systems have to be designed so that the tax is only charged to a certain portion of a purchase, excluding bottled beer and food. The tax means a separate collection and processing procedure to direct the new tax revenue back to the locality. And businesses have to deal with the complaining customers, frustrated patrons and loss of business. Specialized sales taxes don't inspire entrepreneurship and are signs of a regulatory climate that is not business-friendly.

Simply because a sales tax generates revenue does not mean it was "successful." According to the *Pittsburgh Business Times*, within one year the Allegheny County beer tax hike had raised between $10 and $20 million. If the county had projected $100 million in revenue the tax would have been seen as a failure. However, the county had a low projection, and the revenue was more than originally expected. Some in Pittsburgh have argued this shows the tax was a success and did not destroy business. But this does not logically follow. With only one year of data, there is no baseline to measure the revenue against. Given the very public anti-tax sentiment in Allegheny County, it is unlikely that alcohol consumption within county lines increased during the tax, and more likely that initial revenue projections were improperly done.

Given the growing simplicity of shopping online, local sales taxes oftentimes discourage people from shopping locally. Most small businesses ultimately fail in good circumstances, and cities should do all they can to encourage them. In this way sales taxes may ultimately reduce the level of entrepreneurial activity in cities.

Property Taxes

Property taxes are often a main source of revenue for local governments. But these taxes limit business development in three ways. First, the higher the property taxes in business districts, the greater likelihood that a business will move to a nearby area with a more competitive structure. For example, a financial consulting boutique that wants to set up near New York City would have to choose between New York, New Jersey and Connecticut taxes. In 2008, New York collected 21 percent less than New Jersey in property taxes, and 16 percent less than Connecticut. New York's advantage there is clear to entrepreneurs.

Second, high residential property taxes also impact economic growth by discouraging individuals from living in, or close to, the cities they work in. Thus small businesses that cater to local residents—like bakeries and barber shops – see customers leave for suburban areas with lower property tax levels.

Third, property taxes oftentimes are assessed on physical improvements to land—such as construction of a new building or an addition to existing property. As a result, commercial property taxes can be a serious deterrent to expanding existing businesses or opening new ones. Local leaders should weigh carefully the value of the receipts they bring in from property taxes and the competitive nature of their tax code relative to nearby cities.

Tax Credits

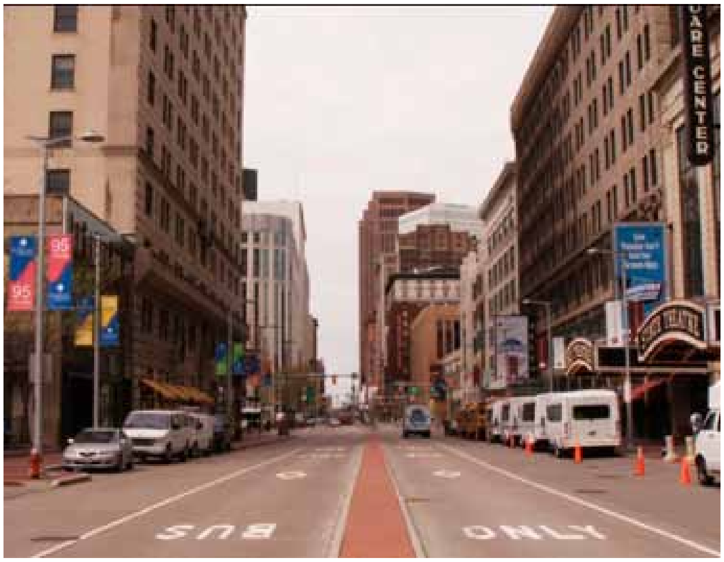
Cities often try to use special, targeted tax breaks to attract businesses. However, while there are anecdotal stories of successful development and growth from special tax credits, the general business and regulatory climate is more often the cause for economic growth. The Kauffman Foundation report concludes:

There is little evidence that governmental expenditures or targeted tax credits aimed at developing clusters from scratch have been successful (at least to date)… there are two drawbacks to firm-specific tax incentives: They are susceptible to being introduced for political rather than purely economic reasons, and they possess a 'zero-sum' aspect (since one community's gain is another's loss). For these reasons, we believe that states and localities should use firm-specific tax policy sparingly.

Whenever cities participate in "firm chasing" policies, offering tax breaks or other benefits to firms to relocate from city to city, they simply change where growth is happening. Instead, cities should focus on building new capacity and encouraging entrepreneurism.

Fees

There are two types of fees that municipal governments charge: related fees and unrelated fees. Fees that are charged to pay directly for related services



are generally appropriate and not much of a problem for business and job growth. Examples of straightforward fees are: processing fees associated with getting a building permit or drivers license and usage fees for access to a park or campground.

City officials should be careful though, to avoid letting fees get out of control—the higher the rate, the more of a burden on citizens. This typically becomes the case when fees are used as a means of raising revenue for the city instead of just covering the costs of services provided, i.e. a building permit shouldn't cost more than the administrative cost of filing and processing.

However, unrelated fees are just taxes by another name. If a fee on one service is used to cover the costs of other city activities, it is simply a higher tax burden. On January 1, 2010, Washington D.C. began charging a 5-cent tax on plastic bags used at grocery stores to fund a river protection program in southwest DC. Whether called a fee or not, this an additional charge per purchase for consumers is not directly related to their activities. The money from the plastic bag fee (tax) is funding a separate city project. City officials argue that plastic bags are bad for the environment and pollute rivers to justify the fee, but that still does change the fact that the non-direct relationship between the two makes this a tax. And the tax is already driving consumers to businesses in nearby Maryland and Virginia where shoppers can avoid the annoyance of the extra charge.

BARRIERS TO ECONOMIC GROWTH

Grand Rapids, Michigan is a shining example of how policies can revitalize a city through encouraging private investment by reducing barriers to entry. In the late 1970s, Grand Rapids was facing over 16 percent unemployment as manufacturing companies began emigrating south where labor costs were cheaper. In response, the city created the Downtown Development Authority, which has been successful in reinvigorating the city through public-private partnerships. A report by the Federal Reserve Bank of Boston finds, "Even in the midst of the current economic recession, downtown Grand Rapids has continued to thrive thanks to 'dedicated local developers.'"

Entrepreneurism is a vital part of economic growth in cities. Research by the Kauffman Foundation finds that growing economies typically are accompanied by small business expansion.[2]

These two basic measures of entrepreneurship—firm size and self-employment rates—also have a good track record of predicting urban success, as measured by employment growth across and within metropolitan areas. In particular, using data from County Business Patterns, we [found] a strong positive relationship exists between metro employment growth and the self-employment rate in the different metro areas.

The question becomes, how can cities promote entrepreneurism? To begin with, local governments must get rid of all the red tape that is holding back individuals from starting new businesses.

Occupational Licensing

Occupational licensing has a significant impact on the labor market and local business development, yet it receives very little attention. During the 1950s, about 4.5 percent of the workforce nationally needed to obtain a license to work. That figure has grown to over 20 percent today. By comparison, minimum wage laws, which price low-skilled workers out of the market, have a direct impact on less than 10 percent of the workforce. Thus, occupational licensing laws directly affect a larger segment of the population than other significant barriers to work.

While occupational licensing laws are billed as a means of protecting the public from negligent, unqualified or otherwise substandard practitioners, in reality they are simply a means of utilizing government regulation to serve narrow economic interests. Such special-interest legislation is designed not to protect consumers, but rather to protect existing business interests from competition.

By banding together and convincing governments to impose new or stricter licensing laws, existing practitioners (who typically are exempted from the new laws through grandfather clauses) can raise the cost of doing business for potential competitors. These barriers to entry reduce competition, allowing the existing practitioners to keep prices and profits higher than they otherwise would be in a truly free market.

Numerous studies have revealed little, if any, improvement in service quality from compulsory licensing. Oftentimes, licensing laws actually reduce service quality and public safety. For example, the costs of regulations reduce competition, thus reducing the pressure on businesses to provide higher-quality services. In addition, the "club mentality" of licensing boards may lead them to prosecute unlicensed workers, but ignore the indiscretions of fellow licensees. And licensing leads to artificially high prices, which may force some consumers to seek black-market services that afford them little or no legal protection against incompetent or harmful practices.

All of these problems with occupational licensing impose a great cost on the economy. By restricting competition, licensing decreases the rate of job growth by an average of 20 percent. The total cost of licensing regulations is estimated at between $34.8 billion and $41.7 billion per year nationally.

Ultimately, the barriers created by occupational licensing are disincentives for entrepreneurs and business development in cities. This diminished level of competition means that consumers have less choice in the marketplace and there is less economic growth.

Permitting and Inspection Barriers

Every city has permitting and inspection procedures. But some cities require more permitting processes and oversight than others. Excessive permitting processes lead to lost time, energy and money—all reasons why businesses might leave oppressive cities.

In Cleveland, it can sometimes take five rounds of review to approve the style and size of a sign to be put outside a private business. According to law professor Jonathan Adler, bars need to have a permit to have a pool table and restaurants even need to have a permit for a DJ to spin records. "That's not the sort of environment that's welcoming to business and welcoming to entrepreneurship," Adler says.

The process of permitting can be improved as well. Cities that still require paperwork and plans to be filed at a local office create unnecessary headaches and waste time. The Internet can be used to significantly reduce the time and labor costs involved with obtaining permits and fees. Businesses should be able to apply for permits online with city staff assigned as caseworkers to each application received in a queue. Caseworkers would be responsible for managing the application with the goal of permitting the business as quickly as possible.

Business Operations Regulations

In a 2001 paper, Reason Foundation reported the story of a husband and wife who teamed up to open their own local hardware store. Using savings from their previous employment, they opened their store in 1997. The start-up phase proved problematic. The most significant problem was the lack of coordination among city agencies. They were unable to find anyone within the city who could provide an overview of what the requirements for setting up a new business were. Ultimately, they "discovered" the requirements through a process of permit and application denials from various agencies.

Each agency would deny their permit or license until they had obtained X, Y and Z inspections, permits or licenses. Among the permits and licenses they had to obtain were the general business license, a building and zoning permit, a fire permit, a permit for making keys, a health department permit and a sign permit. They are unsure even today if they have actually acquired all of the inspections, permits and licenses required by law and are concerned that they may be in violation of the one of the local codes.

Ideally, cities should have a single department or agency that can provide "one-stop" permitting

and licensing along with all relevant information on zoning, inspections and taxes for small businesses. Entrepreneurs should be able to research requirements on the Internet on a single website. The easier it is to start a business, or expand a business the more vibrant the local economy will be.

Eminent Domain and Regulatory Takings

Local governments have the power of eminent domain to use sparingly for the general good of the public. An example of appropriate use is when it might be necessary to expand utilities facilities or a highway. However, cities have increasingly been abusing the power of eminent domain to give prime real estate to choice business ventures on the hope that the new companies will provide more tax revenues. Since the widespread adoption of municipal zoning in the United States in the early 20th century there has been an expansion in the character and scope of local land controls and an increasing recognition that land use regulation significantly infringes on private property rights.

In the famous 2005 U.S. Supreme Court case *Kelo vs. City of New London*, the local government took the land of private citizens so that Pfizer could expand a research center. The high court ruled against Susette Kelo and plaintiffs, allowing the city to take the property. However, four years after the ruling, in the wake of the economic downturn and health care debate, Pfizer announced it was shutting down its New London facility. Not only were property rights violated, but the city project—which didn't focus on entrepreneurism—was a failure.

A recent report from the Institute for Justice cites how this has also become a pervasive problem for New York:

"Over the past decade, a host of government jurisdictions and agencies statewide have condemned or threatened to condemn homes and small businesses for the New York Stock Exchange, The New York Times*, IKEA, Costco, and Stop & Shop. An inner-city church lost its future home to eminent domain for commercial development that never came to pass. Scores of small business owners have been threatened with seizure for a private university in Harlem and for office space in Queens and Syracuse. Older homes were on the chopping block near Buffalo, simply so newer homes could be built. From Montauk Point to Niagara Falls, every community in the Empire State is subject to what the U.S. Supreme Court has accurately called the 'despotic power.'"*

As the regulatory scheme influencing local land use has grown more prescriptive and restrictive, there has been an increasing curtailment of private property rights. Landowners in many cities nationwide have been restricted in their ability to use their land in the ways that they had intended when they purchased their property, dramatically reducing their property's value and imposing an economic hardship on them.

CONCLUSION

Policies that focus on making entrepreneurship easy and affordable will be milestones in leading a city to a thriving economy. Reducing the tax burden on small businesses will encourage new types of stores, services and production facilities to come back in, or stay in, city limits. Curtailing red tape and licensing procedures will also make cities more attractive to business development.

When approaching this problem, local leaders should focus on the achievable. A practical key to successful economic development policy is the ability of local leaders to be realistic in their expectations and in the programs they create to achieve them. For once great American cities, it will take many steps to clear out many of the hurdles currently confronting businesses. Cities must focus on what they can achieve, not on visions, hopes or aspirations that are no longer within reach or impossible to achieve under the best of circumstances.

Sometimes, policymakers tend to take a shotgun approach to economic development policy that captures the following philosophy: try as many ideas as you can and hope two or three have an impact. This approach tends to diffuse accountability in the process, and often sets in motion initiatives that work at cross-purposes. A more effective strategy has been for local leaders to identify two or three key areas and goals, and then develop a timed, phased action plan to achieve them. The results are easier to measure, and implementation is clear and more likely to succeed.

Whatever the focus, city officials should keep reducing the tax burden and untangling regulatory webs as the primary goals. Focusing on this will allow cities to take great strides towards fostering vibrant, sustainable economic growth.

ABOUT THE AUTHOR

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ENDNOTES

1 Certain types of government investments, such as road and sewer infrastructure, do help lay a broad-based foundation for private growth. However, their job creation and impact on local wages are relatively small.

2 The author notes: "Without more statistical work, we cannot determine whether entrepreneurship is driving regional economic success or whether it is other way around. Indeed, both propositions could be true. Whichever happens to be the case, we nonetheless find it important that entrepreneurship and regional economic success seem to be