

# INNER CITIES

## AND LONG-RUN

# GOVERNMENT POLICY

*by Robert Krol and Shirley Svorny*

The inner-city turmoil of the 1960s led to a wave of public programs intended to create jobs, end poverty, and encourage economic development. After 30 years, Americans have good reason to question whether these programs can actually promote urban economic development. There is evidence that job training programs have few beneficial long-term effects, and that they may stigmatize workers, actually making it harder for them to obtain employment. Poverty programs yield

negative incentives that affect generations of families on public assistance.

In response to these concerns, government officials are turning toward an alternative group of programs designed to increase incentives for urban investment and growth: Community Development Banks, the Community Reinvestment Act (CRA), and Enterprise or Empowerment Zones. It is argued that these programs—aimed at directing federal funds toward inner-city investment—will encourage urban economic development and lead to better job matches for inner-city residents.

But these new programs are likely to prove as ill-conceived as their predecessors. As the programs before them, they are based on the premise that the problems of poverty and joblessness are amenable to the kinds of policies that government institutionally can bring to bear. They will fail because the only sustainable source of jobs and wealth is the private sector. Entrepreneurs see opportunities and respond by organizing productive activity. With their own

dollars and reputations at risk, they undertake only those activities that are truly likely to succeed.

Directing funds to the inner city through Community Development Banks, the CRA, and Enterprise or Empowerment Zones would transfer resources from productive endeavors to those that are less productive. Private credit markets allocate resources to individuals with the best prospect of creating productive opportunities and, therefore, jobs. Government programs that reallocate capital and constrain its uses to a different range of locations and endeavors necessarily limit the potential usefulness of those funds.

On an international level, the poorest countries are those with governments that constrain or direct investment. It seems ironic that, as the record of the socialist countries has demonstrated the flaws in government planning, the United States increasingly is considering investment planning at home.

The call for an urban "Marshall Plan" seems to ignore the fact that federal aid to cities—broadly defined

to include the war on poverty and various aid programs—has been substantial. Researchers at the Cato Institute calculate that over \$3 trillion (in 1993 dollars) has been spent since the 1960s—the equivalent of 25 Marshall Plans.

**Community Development Banks.** As initially conceived, community development banks are to channel federal funds to inner-city investment. The goal is to create jobs for the inner-city poor. The first Clinton Administration budget allocated \$382 million over a four-year period for this program. These funds, to be matched by private or state funds, provide grants of up to \$5 million per institution. Existing community development lenders are eligible for funds, but most financial institutions doing business outside the target areas are excluded. A nine-member board is to allocate the federal funds among institutions.

The most obvious problem is that it is unlikely that officials of community development banks will have incentives or be able to identify the most productive investments. The lending of government money will politicize the loan process. The viability of any given proposed investment may not be the dominant criterion for lending decisions. We have seen this politicization of fund allocation with job training funds at both the state and federal level.

A second problem will be the lack of diversity in the portfolios of community development banks. With their loans concentrated in high risk areas, they will be vulnerable to failure should the local economy take a turn for the worst.

Not only will resources be directed on average to relatively poor investments, but the implementation of the program will draw resources that could be productively invested elsewhere. Although private sector jobs may be "created" through lending of this sort, it will be at the expense of an even greater number of jobs that would result from the private market outcome. The available evidence suggests that private entrepreneurs are better at picking productive, job-creating opportunities than are public officials or their representatives.

**Community Reinvestment Act.** The CRA is a closely related piece of legislation, also aimed at increasing inner-city investment by encouraging depository institutions to expand credit availability in low and moderate income neighborhoods within their service areas. CRA performance has been taken into account by regulators evaluating bank applications for federal deposit insurance, branch expansion or relocation, and mergers. For example, last

year, when the Federal Reserve did not approve a proposed takeover by Shawmut Bank, Shawmut's CRA rating was an important factor in the Federal Reserve decision. The Clinton Administration proposes to strengthen the CRA by adding explicit lending goals for banks.

The CRA forces banks that wish to locate in inner cities to make loans that they otherwise would choose not to make—loans that are riskier and that bear a higher likelihood of default—without compensation in that banks are prohibited from charging higher interest rates on these loans. What sounds like a great idea to politicians (and to those unfamiliar with the functioning of competitive financial markets) is likely to discourage banks from opening branches in the inner city. There are also significant administrative costs associated with compliance. Finally, because CRA ratings are public, it makes the operation of a private bank more political.

Partially as a consequence of this type of legislation, many inner city residents must rely on non-bank firms which provide check cashing and other services for a fee (made higher by the lack of competition from banks). Inner-city residents who want the services of a bank must seek those services elsewhere. The solution is to replace the CRA with policies that allow banks

to enter inner-city markets free of lending constraints that limit their ability to earn a normal return. Even the prospect of future constraints acts as a deterrent to entry.

**Enterprise or Empowerment Zones.** Enterprise zones provide tax breaks, subsidies, and regulatory relief for firms locating in specified areas of inner cities.

Proponents suggest that these areas be selected on the basis of need as measured by unemployment rates, income levels, or other such criteria. Empowerment zones are similar constructs, but focus on subsidizing labor costs in such areas.

The Clinton Administration included empowerment and enterprise zone legislation in last year's deficit reduction package. Funding was authorized for nine empowerment zones, five of which are in large cities. The plan includes \$2.5 billion in wage subsidies and \$720 million of direct federal grant money. It also bestows tax-exempt status on non-manufacturing business bond issues for firms in empowerment zones, the exact cost of which will be determined as firms choose to take advantage of this benefit. In addition, \$280 million in grant money is budgeted for 95 enterprise zones. These zones are permitted the same tax-exempt bond status granted to the empowerment zones.



Inner city decay and development.

The hope of those who crafted the legislation is that individuals or firms that otherwise would choose to invest elsewhere will be encouraged to consider the inner city. It is not clear, however, that the government can offer sufficiently large subsidies to attract firms to inner cities. Crime is a significant deterrent to entry. Also, if firms are required to hire specific workers or to use specific subcontractors as a condition for enterprise/empowerment subsidies, the costs may be too large.

Entrants must also be aware that the long-term viability of such investments is questionable, since the costs of doing business in the inner city are reduced only for the period during which government subsidies continue. The primary problem from a long-run perspective is that shifting productive endeavors to areas where the return is relatively low (so that firms must be sustained by direct and indirect subsidies) cannot generate economic growth for the economy as a whole.

The idea of reducing taxes to spur economic development makes sense, but embedding it in an enterprise zone framework does not. There is conclusive evidence that a reduction in taxes at the state or city level results in greater employment and personal income. But there is no evidence that tax breaks in an arbitrary or politically chosen geographic area will lead to more jobs for inner-city residents.

**An Alternative Approach.** On the surface, it may seem reasonable to predict that these programs will work. Public officials will grandstand at the opening of new firms in the inner city. But the shift of funds away from other productive endeavors means that jobs and productive opportunities elsewhere are lost. Once started, these programs will be hard to stop. Powerful constituencies will develop hampering any redistribution of public funds, even in the presence of hard evidence that such programs fail to meet their stated goals. Government job training programs provide strong evidence of this phenomenon. Public job training programs are actively promoted despite evidence indicating that most are ineffective.

As an alternative, we propose solutions that will foster economic activity and enhance job opportunities for all workers, including those in the inner city. This more effective approach for solving the problems of the inner cities in the U.S. should encompass three fundamental principles:

- *Government programs directed at cities should be designed to facilitate the movement of labor, capital and entrepreneurship into and out of central cities. The most efficient policies are those which help move resources to their most productive use.*

- *Government programs should not try to direct the location of capital, labor, and entrepreneurship. The government's comparative advantage does not lie in discovering profitable and productive economic opportunities.*

- *Government policymakers must realize that improvement of individual standards of living ultimately is the responsibility of individuals. An individual's employment status and earning ability are the outcomes of many decisions outside the ability of the government to influence. At best, we can only lend a helping hand and avoid discouraging individual initiative.*

The evidence suggests that several government policies would promote economic growth in inner cities. Policies that enhance worker mobility must be initiated. Laws and regulations that raise the costs of using labor must be eliminated. Education reform has the potential to improve the job skills of inner-city residents. Finally, deregulation in such areas as banking and trucking suggests that there may be gains from other, similar types of regulatory reform.

**Policy Recommendations.** Cities have changed substantially since World War II and are now highly decentralized. Land-intensive manufacturing has gradually moved out of central city areas; less land-intensive, mainly service industries (like financial services) remain. According to 1990 census data, a majority of Americans now live in the suburbs, leading to significant employment growth in the suburbs. Recent data from the Urban Institute show that over two-thirds of total employment growth from 1976 to 1986 occurred outside central cities. By 1986, more than 60 percent of all manufacturing jobs were located in the suburbs. With blue-collar jobs in the suburbs, and low-skilled workers in the inner city, there appears to be a growing spatial mismatch in jobs and job skills for inner-city residents.

Instead of trying to create jobs in areas too risky or unprofitable for private investment, the government should focus on easing access to viable employment for the inner-city poor. Urban policies to promote employment opportunities, improve living conditions, and meet the needs of the changing urban landscape should be designed with an outward orientation. Rather than trying to keep workers within the urban core, these policies should promote mobility, enabling individuals to take advantage of opportunities wherever they arise.

City transportation priorities need substantial change. Rather than investing in costly fixed-rail systems, cities need to emphasize more flexible and less costly bus lines. Cities in which the municipal bus lines have a monopoly on bus routes and in which taxi permits are constrained need to allow competition in the provision of transportation services to the urban poor. Although many cities tolerate the presence of illegal transportation networks, the clandestine nature of these operations necessarily raises the costs and reduces the efficiency of their operations in that they may not use inexpensive methods of advertising, etc.

Perhaps even more important than enhancing worker mobility, laws and regulations that raise the costs of using labor must be reconsidered. These are the regulations with

the most direct relationship to job creation. Economists have shown that the minimum wage has disemployment effects, especially for inner-city youths. Besides reducing job opportunities for unskilled workers, minimum-wage legislation prohibits apprenticeship-type arrangements where workers could offer to work for below-market wages in return for training.

Medicare and Social Security are financed by taxes borne by labor. Evidence that the financial status of the elderly has improved considerably relative to that of wage earners has not stemmed the tide of this wealth transfer/tax on labor. Government employee benefit mandates also may add to the cost of hiring workers. Judgments against employers in wrongful termination cases raise the costs of using labor further. In this country we claim that job creation is of the utmost importance, yet we discourage it in many ways.

Improvement in education is another road to inner-city well-being. Wages for educated, skilled workers have grown dramatically during the 1980s and 1990s relative to those for unskilled workers, reversing a trend toward convergence during the 1970s. Researchers attribute this to many factors, the most likely being the change in the demand for labor related to technological innovation.

At present, the United States invests heavily in education, but there is growing evidence that these resources could be used more wisely. A "charter" school in the large, financially-strapped, conflict-ridden Los Angeles Unified School District was able, remarkably, to reduce class size, increase student attendance to near-perfect rates, purchase computers, add classrooms and staff, and save substantial funds for the purchase of adjacent properties, all in its first year of independence from district control!

Two recent studies have found that where private and public schools compete, there are measurable positive effects on student performance. There is evidence that students learn more in countries where public funding of both public and private schools allows them to compete for students. Data from the United States reveal that greater private school competitiveness increases public school outcomes.

It appears that the vast resources directed to public education can produce greater dividends if the conditions under which public schools operate are changed. Local school autonomy and competition are important institutional reforms that must be considered. Administrators and teachers who show initiative must be rewarded. Those that show little or no initiative must not be protected.

Finally, regulatory reform at all levels of government can promote urban economic development. For example, recent work shows that states that allow branch banking and encourage interstate banking through bank holding company activity have more jobs and greater personal income on a per capita basis, other things equal. In addition, research shows that customers in states allowing branching and interstate banking can borrow at lower interest rates and receive higher deposit rates. Intrastate trucking rules raise rates in some areas, raising firms' costs and hampering their ability to serve distant in-state mar-

kets. There are many other areas in which government regulation increases the costs of operating a business and, therefore, limits job creation.

Governments can encourage economic activity also by adopting permitting and environmental regulations that are efficient. Where cities make it difficult for firms to establish residence, either because city regulations subject firms to lengthy or costly permit approval processes, new firms will be

more reluctant to enter. Cities can reduce the costs of these processes by adopting efficient "one-stop" permitting, as Los Angeles Mayor Richard Riordan has proposed, and by choosing environmental control mechanisms that reduce the total costs of emissions reduction (as with the trading of rights to pollute).

In short, we argue that a variety of programs can promote growth. Most of them involve little government direction of economic activity. Most involve deregulation and increased competition. The dividend will be opportunity in the inner city and elsewhere. And as opportunities increase, all residents will benefit from the residual reduction in crime. Hopefully, as jurisdictions experiment with some deregulation, as they have with banking and trucking, and are beginning to do in education, the evidence will persuade more people to support these types of programs. ■

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