
Local Economic Development

Chapter 3

The focus of this report is on state-level business financial incentive programs operated by the Department of Trade and Economic Development (DTED). However, there are a number of other local economic development efforts going on in the state that in many respects overshadow the state-level programs. In order to put the state-level programs in context, in this chapter we discuss the interaction of the Economic Recovery Fund with local governments. We asked:

- **How has the Economic Recovery Fund interacted with local economic development programs?**
- **Has the state received the repayments from past loans? How many loans have been “forgiven?” What is the repayment schedule to the General Fund for future years?**
- **How has the money retained in local revolving loan funds been used?**

LOCAL ECONOMIC DEVELOPMENT

In reviewing the Economic Recovery Fund we were somewhat surprised to learn that it was only a small component of most of the projects it financed. We found:

- **Local and regional level programs are very important components of economic development in Minnesota.**

For example, we found that most projects funded by the Economic Recovery Fund between 1991 and 1995 had multiple participants. Almost all projects had local or regional financial participants such as city, county, or regional revolving loan funds, tax increment financing (TIF), Economic Development Agencies (EDAs), Regional Development Commissions, regional initiative funds, power companies, and a wide variety of other financial entities. Also, as we will discuss later in this chapter, our survey of local revolving loan programs showed capital balances of over \$110 million on June 30, 1995.

Most projects funded by the Economic Recovery Fund had additional public funding.

The Economic Recovery Fund provided only 29 percent of public financing for the projects we reviewed.

We found that the average Economic Recovery Fund project between 1991 and 1995 had three sources of financing in addition to the state. Public financing other than the Economic Recovery Fund was a part of 136 of the 176 funded projects: 35 of the projects used local revolving loan funds, 40 used tax increment financing, and 56 used loans from the Minnesota initiative funds. These 136 projects received an average of over \$586,000 in public grants or loans for a total of about \$80 million, not including \$33 million from the Economic Recovery Fund program. In other words, the state program provided only slightly over 29 percent of the public financing for the projects that were funded. As a result, one should view with caution the assertions of DTED or local loan and grant providers about the number of jobs created, the amount of funds leveraged, and the cost per job created, because none of the numbers we reviewed considered that there were multiple sources of public subsidy for the projects. In fact, DTED considers most other publicly subsidized financing to be leveraged funds in its application scoring process.

We found that tax increment financing (TIF) is probably the economic development tool used most often by cities. Basically, tax increment financing allows a city to capture the additional tax paid by new businesses within a tax increment district for a certain period for use in a variety of ways, including economic development. TIF is commonly used to help companies build new buildings, acquire capital equipment, make site improvements, and for infrastructure improvements.¹ In 1995, there was over \$275 million in tax increments available for use in Minnesota annually, mostly for redevelopment and economic development purposes.

LOAN REPAYMENTS AND DEFAULTS

Loans made from the state portion of the Economic Recovery Fund are repaid by businesses to local communities and to the state. Local units of government receive and keep the first \$100,000 for use in local revolving loan programs. The state receives repayment for loans greater than \$100,000. Repayment of loans are deposited in the General Fund. Funds from the federal CDBG program are all retained by the local government.

We found that:

- **The state has received repayment for nearly all past loans over \$100,000, although some companies have gone out of business and defaulted.**

Table 3.1 shows that since 1984, 33 of 318 grantees (10.4 percent) have gone out of business, defaulting on 6.7 percent of the funds lent. A few other companies have gone out of business but have kept current on the loans because of personal guarantees by the business owners. For federally financed projects, 11.3 percent

¹ For more information about tax increment financing, see our previous report on the subject *Tax Increment Financing* (St. Paul: Office of the Legislative Auditor, 1987), and forthcoming *Tax Increment Financing* (St. Paul: Office of the Legislative Auditor, 1996).

Table 3.1: Economic Recovery Fund, FY 1985-95, Distribution of Funds and Company Defaults by Year

Year	State				Federal			
	Number of Loans	Dollars	Number of Defaults	Amount of Defaulted Loans	Number of Loans	Dollars	Number of Defaults	Amount of Defaulted Loans
1985	32	\$5,909,598	7	\$1,273,800	9	\$1,523,596	1	\$227,427
1986	30	4,998,774	6	840,561	10	1,852,244		
1987	36	5,665,712	9	1,220,059	11	2,065,305	3	307,899
1988	32	5,454,700	5	325,000	10	1,760,531	3	700,000
1989	25	5,926,139	4	364,538	13	3,775,318	2	536,000
1990	26	5,621,600	1	191,200	8	2,263,500	1	216,000
1991	25	5,863,350			5	1,990,000		
1992	23	5,347,490			8	1,977,314	1	190,000
1993	29	5,315,920			4	977,739		
1994	31	7,353,248	1	70,000	4	1,393,000		
1995	29	6,412,800			15	4,751,500		
Total	318	\$63,869,331	33	\$4,285,158	97	\$24,330,047	11	\$2,177,326

Note: One additional loan made in 1993 for \$500,000 is not technically in default status because the company is out of business and has defaulted on other loans for the project. The department does not receive repayment of federal loans or the first \$100,000 of state loans and does not consistently track their repayment to local governments. Therefore, the default figures may be understated.

Source: Department of Trade and Economic Development.

The default rate appears to be decreasing.

of the companies have gone out of business, defaulting on 8.9 percent of the funds lent.

These figures likely understate the default rate on the more recent loans because many companies have not yet had to make payments. Many loans were originally structured to begin repayment of principal and interest at some date between 5 and 10 years in the future. The table also shows that the default rate appears to have decreased in recent years. In part that is because some of the more recent loans have not had to begin repayment to the state yet. It is also probably partially attributable to a change of policy, initiated by former DTED Commissioner Peter Gillette, to not make loans for working capital. Loans for working capital tend to be riskier and have a higher default rate.

Forgivable loans are loans that have a term and interest rate but are “forgiven” in whole or part depending on job creation and retention goals specified in the loan agreement. It appears that the number of forgivable loans has increased in recent years. We found that between 1991 and 1995 there have been 57 grants or forgivable loans made from the state Economic Recovery Fund. In comparison there were 26 grants or forgivable loans made from the state program in the five years between 1985 and 1989.

The state General Fund is scheduled to receive repayments of \$1,205,000 in fiscal year 1996, \$1,455,000 in fiscal year 1997, and \$1,174,000 in fiscal year 1998. As

of June 30, 1995, over \$1.7 million had been repaid to the General Fund and an additional \$19.3 million is scheduled to be repaid in the future.

As of June 30, 1995, almost \$3.5 million in loans had been repaid to the Economic Recovery Fund to be lent again. Since 1995, all repayments have gone to the state's General Fund.

LOCAL REVOLVING LOAN FUNDS

An interesting feature of the Economic Recovery Fund is the use of loan repayments to capitalize local revolving loan funds. The repayments from loans made from the federal Small Cities Community Development Block Grant program all stay with the local community, and up to \$100,000 in repayments from the state Economic Recovery Grant program also may stay with the local community.

At our roundtable discussion in mid-1995, Legislators expressed interest in how the local loan funds are being used. Unfortunately, there is no central source of information about local revolving loan funds. A 1989 survey identified 157 funds with over \$42 million in capital but no more current information was available.² As a result, we conducted a survey of local governments to identify revolving loan funds and to find out about the uses of the funds. We surveyed all communities that had received economic recovery loans, all cities over 1,000 in population, and all 87 counties.³ We sent a total of 531 surveys and received 483 responses for a response rate of 90 percent.⁴ We believe we have identified almost all of the local revolving loan funds in the state.

Our survey revealed the existence of over 237 revolving loan funds.⁵ We found that the use of local revolving funds has continued to increase. Since the 1989 survey, 80 additional funds have formed and the amount of capital available in the loan funds rose from \$42 million in 1989 to over \$110 million in 1995. We heard from many communities that they did not have a revolving loan fund but that they might form one. Although one community started its fund in 1948, we found over half of the communities responding to our survey had started their loan funds since 1988, with 25 originating in 1994 alone. Only 14 communities had loan funds before the start of the Economic Recovery Fund in 1984.

The fact that the state will let communities keep a portion of Economic Recovery Fund repayments has created an incentive for communities to start revolving loan funds. DTED has been the source of capital for 129 of the 237 funds, either through the Small Cities or Recovery Grant program. Economic Development Ad-

We identified over 237 revolving loan funds with over \$110 million in total assets.

² Tom Stinson and Andrea Lubov, "Revolving Loan Funds: Funding Economic Development in Non-Metro Cities," *Minnesota Agricultural Economist*, No. 669, Spring 1992, 1-11.

³ We also sent surveys to any respondents to Stinson and Lubov's 1989 survey that were not already on our list.

⁴ We included a postcard for communities to send back if they did not have an economic development revolving loan fund.

⁵ An additional 15 surveys were received after our analysis was completed.

ministration or Urban Development Action Grants capitalized 23 of the funds and other sources capitalized 96 of the funds. Most often cities contributed to the funds from their general revenues or they contributed excess TIF reserves to capitalize their funds. However, cities have started funds with sources of capital as varied as local business persons' contributions, federal government grants, and grants from various foundations.

City councils or city economic development administration agencies are responsible for administering most revolving loan funds (over two-thirds). Other administrative agencies include Housing and Redevelopment Agencies (4.7 percent), Regional Initiative Funds (3.9 percent), Port Authorities (3.4 percent), and Regional Development Commissions (1.7 percent).

Table 3.2 shows the distribution and total capital available by region. The table shows that loan funds are present throughout the state, but they are pervasive in southeastern Minnesota with 64 funds and a capitalization of over \$23 million. The Minneapolis Community Development Agency and the City of St. Paul operate several loan programs that are not revolving loan programs. As a result, we understate the amount of capital available in the metropolitan area from loan funds.

Table 3.2: Revolving Loan Funds, June 30, 1995, Total Capital by Region

<u>Region</u>	<u>Number of Funds</u>	<u>Total Capital</u>
Central	38	\$8,556,533
Metro	29	34,618,467
Northeast	21	12,342,553
Northwest	18	10,694,226
Southeast	64	23,490,619
Southwest	38	12,888,299
West Central	24	7,849,354
State Total	232 ^a	\$110,440,071

Source: Program Evaluation Division analysis of survey of local revolving loan funds, December 1995.

^aThere are an additional two funds in the Central region, one fund in the Northwest region, and two funds in Southwest region that responded to the survey but the total capital was missing.

There is a lack of lending opportunities for 47 percent of funds.

The 237 funds made almost 2,300 loans between 1990 and 1994. However, 27 funds made no loans, another 27 made only one, and 20 funds made only two loans during the five year period.⁶ The most active fund made 287 loans, but the average number of loans made was ten and the median number was five. Twelve percent of funds had no loans outstanding on June 30, 1995; the median fund had four loans outstanding and one fund had 250 loans. Overall, this suggests a lack of lending opportunities for some funds. Forty-seven percent of fund administrators told us they had more capital available than the amount of loans requested during the previous 12 months, 23.9 percent responded that the amount of capital was equal to the loans requested, and 22.9 percent said that the capital was inadequate

⁶ The reader should note that some of these funds were recently established.

for the loans requested. Although there was over \$110 million in total capital state-wide, the median fund had only \$101,000 in total assets. Of the \$110 million in total assets, there was over \$35 million available to lend.

Partially as a result of the average fund's small capitalization, the average loan size is small. Twenty-seven percent of the loans are for less than \$10,000, 20 percent are for between \$10,000 and \$20,000, and another 26 percent are for between \$20,000 and \$50,000.

Local revolving loan funds are used more flexibly than state Economic Recovery funds.

In Table 3.3 we show local revolving loan funds are used more flexibly than state funds. The primary use was for buildings and/or equipment although local governments were more likely to make loans for working capital and inventory financing than the state. Table 3.4 shows that local funds focus on existing and startup businesses, but they are more likely to fund retail and service businesses than state programs.

Table 3.3: Revolving Loan Funds, Types of Uses

<u>Use</u>	<u>Percent of Respondents</u>
Buildings/Equipment	89.4%
Other Fixed Assets	44.0
Working Capital	44.5
Inventory	41.3
Bridge Financing	19.7
Loan Guarantee	13.3
Interest Writedown	7.3
Infrastructure	11.0
Equity	4.1
Other - Storefront Rehabilitation	8.3

Source: Program Evaluation Division analysis of survey of local revolving loan funds, December 1995.

Table 3.4: Revolving Loan Funds, Types of Businesses That Can Receive Loans

<u>Type of Business</u>	<u>Percent of Respondents</u>
Existing businesses located in your area	95.6%
Startup businesses	89.1
Businesses in other states that will relocate or expand in your area	71.6
Businesses in Minnesota that will relocate or expand in your area	74.7
Manufacturing/Industrial firms	88.6
Retail firms	64.6
Service firms	65.5
Other	7.4

Source: Program Evaluation Division analysis of survey of local revolving loan funds, December 1995.

Regional administration of revolving loan funds might allow for more use of loanable funds and more portfolio diversification.

We found that over two-thirds (67.4 percent) of the funds had written loan policies governing their use. Almost 50 percent restricted the total portion of a project they would fund. Of that 50 percent, over 85 percent restricted the amount they would fund to less than one-half of the total project's cost. Over 50 percent of the funds also restricted the maximum amount loaned. The restrictions fit the small capitalization of most of the funds. Over 85 percent of the funds had loan limits less than \$100,000. One-half of funds had a maximum loan amount of \$50,000 and the average fund's maximum limit was \$69,000. Almost all funds (89 percent) required equity or private financing participation by the business.

We reviewed the many loan policies that were sent to us by communities with revolving loan funds. There was a wide range in the sophistication of the policies. They varied from one page statements that there were no restrictions on the use of the funds to quite sophisticated policies that reflected careful thought about the use and targeting of the funds to be lent. The typical terms offered on the loans were 3 years for working capital, 7 to 10 years for equipment, and 10 to 20 years for real estate, although some communities offered longer terms. Interest rates were below market rates in most cases. Many funds individually negotiate rates based on job creation. All policies we reviewed required some collateral for the loan and many required personal guarantees.

Many policies explicitly stated that the funds could not be used in such a way that they would provide an unfair competitive advantage to existing local businesses. For that reason many funds also prohibited loans to retail firms. Almost all funds would not allow the refinancing of existing debt or speculative land investments.

Based on our findings we believe a suggestion first made by Tom Stinson and Margaret Dewar makes sense. They recommended that instead of individual communities having loan funds they should be managed on a regional level.⁷ Administering loan funds regionally allows for portfolio diversification that only the very largest funds have now. Most funds now are very vulnerable to defaults because they are so small in size. Regional funds also could avoid the problem of having large amounts of capital not lent out to businesses because of a lack of good lending opportunities. As we noted above, 47 percent of funds noted a lack of lending opportunities in 1995. Regional funds could also benefit from economies of scale and could afford more professional management than individual communities. Therefore, if the Legislature wants to continue to provide loan funds to local communities, we recommend:

- **The revolving loan funds should be administered at the regional level.**

Potentially the regional initiative funds or regional development commissions could serve as administrative entities for regional revolving loan funds. If the initiative funds were to manage the loan funds, oversight from DTED would be needed since the funds are not public bodies. Another possibility could be counties joining together in joint powers agreements to administer the loan programs.

⁷ "Strategies for Economic Development," *CURA Reporter*, May 1995, University of Minnesota, 1.