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ECONOMIC DEVELOPMENT

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PREFACE

In May 1984 the Legislative Audit Commission directed the Program Evaluation Division to study economic development programs in Minnesota. This report focuses on the economic and tourism development programs administered by the Department of Energy and Economic Development and the Iron Range Resources and Rehabilitation Board.

It should be noted that these two agencies have quite different responsibilities and funding sources. The Department of Energy and Economic Development is the principal state agency responsible for state economic development and tourism promotion programs and is funded primarily through the state's General Fund. The department also operates the state's energy programs. The Iron Range Resources and Rehabilitation Board is responsible for addressing economic and environmental problems in the taconite relief area in northeastern Minnesota. The board is funded primarily by taconite production taxes levied on area mining companies in lieu of local property taxes.

Despite these differences, it is important that both these agencies use public funds for economic development in the most productive way. This report recommends a number of changes that we think are needed to ensure that state funds spent by the Department of Energy and Economic Development and regional funds spent by the Iron Range Resources and Rehabilitation Board are effective in generating economic growth for the state and the Iron Range. The report also recommends to the Legislature a number of changes that we believe will improve the effectiveness of the state's economic development programs.

We thank the management and staff of the Department of Energy and Economic Development and the Iron Range Resources and Rehabilitation Board for the cooperation and assistance we received during the study. In addition, we thank the many local development officials we contacted for insights on the implementation of economic development programs.

This study was conducted by Ed Burek, Dan Jacobson, Judy Poferl, Marie Scheer, and John Yunker (project manager).

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March 16, 1985

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In the last two years, the number of and expenditures for economic development programs have increased dramatically in Minnesota. At the state level, increased spending includes: $35.6 million for enterprise zone tax credits, $15 million for loans and loan guarantees from the newly created Economic Development Fund, $6 million for a new Economic Recovery Fund, a $6.1 million increase for the state tourism promotion budget, $6 million to help develop a technology corridor in Minneapolis, $1.1 million for an economic development marketing program, and three new tax credits to encourage investment in and growth of small businesses. These new efforts have been initiated for two main reasons. First, the 1981-82 national recession hurt Minnesota somewhat worse than the rest of the nation as a whole. During other recent national recessions, Minnesota had generally fared better than the nation. Second, state officials recognized that states have become increasingly competitive with each other in seeking to attract new or expanded businesses and tourists. As a result, the state has greatly increased spending for economic development and tourism promotion programs and significantly increased staff resources at the Department of Energy and Economic Development (DEED).

Due to the severe decline of the taconite mining industry in northeastern Minnesota, the Legislature also permitted the Iron Range Resources and Rehabilitation Board (IRRRB) to use money from the Northeast Minnesota Economic Protection Trust Fund (NEPF). The NEPF, or "2002 Fund," was originally established so that the Iron Range area would have access to funds to address economic problems that would result when the area's mineral resources were depleted in the year 2002. The fund was financed by taconite production taxes levied on area mining companies in lieu of local property taxes. Through FY 1984, the IRRRB has received more than $30 million from the NEPF. With these and other funds provided by taconite production taxes, the IRRRB has allocated significant resources to economic and tourism development projects. The IRRRB has committed $8.5 million for expanding the Iron Range Interpretative Center and has plans to spend an additional $4 million or more on center expansion. Also, the IRRRB has spent: $6.9 million to develop the Giants Ridge ski area, more than $5 million for loans to Iron Range businesses and resorts, $5 million for a common bond reserve fund to secure industrial revenue bonds issued by the IRRRB and Iron Range cities, $4.9 million for grants and loans to Iron Range school districts and other public agencies to convert boilers to burn wood or peat, $1.6 million for research on the economic feasibility of producing peat in northeastern Minnesota, and $1.4 million to help develop a demonstration facility for producing steel and pig iron from taconite using plasma-smelt technology.

This report examines whether the state programs administered by the Department of Energy and Economic Development and the regional programs operated by the Iron Range Resources and Rehabilitation Board are likely to be effective in creating jobs for Minnesotans. We are somewhat skeptical that any economic development program can have a significant impact on state or regional economies. National and international economic factors, state and local taxes, education, and production and transportation costs undoubtedly have far more impact on a state's economy than economic development programs. Even though they are not major factors, economic development programs may have some marginal impact on economic activity. Just how much impact such programs can have is difficult to measure. However, the potential impact is greater if the programs are directed at the types of businesses and economic sectors that are most likely to create jobs if financial incentives are provided or promotional activities increased. In addition, programs are more likely to be effective if development agencies adequately analyze benefits and costs of proposed projects before proceeding. As a result, this report focuses on how well programs are designed and how well individual projects are analyzed.

A. DEPARTMENT OF ENERGY AND ECONOMIC DEVELOPMENT

The Department of Energy and Economic Development (DEED) has faced the difficult task of implementing a number of important new or greatly expanded programs in a short period of time. These economic development programs were authorized or expanded by the Legislature less than two years ago. In some instances, the programs were authorized during the 1984 legislative session, less than one year ago.

Considering the scope of this task, we believe that the department has generally done a good job in implementing these programs. The department has appropriately targeted manufacturing firms for financial assistance through Economic Recovery Fund grants and its major loan programs, the Small Business Development Loan Program and the Minnesota Fund Program. In general, it is more productive to target financial assistance to manufacturing firms than to other types of businesses.

1. LOANS TO BUSINESSES

However, simply providing financial assistance to manufacturing businesses that apply for these programs does not ensure that the programs are creating jobs. In the future, the department needs to more carefully review loan and grant applications from manufacturing firms to ensure that economic development funds are used in the most cost-effective manner. In particular:

- The department should examine the impact that a publicly subsidized business expansion might have on employment at other Minnesota businesses competing in the same product market.

This issue is not being systematically examined now because the loan review process focuses primarily on financial considerations. The department should involve economic analysts from its Policy Analysis Division in the review of proposed loans and grants.

Also:

- The department should more rigorously review applications to ensure that public funds are not used to displace private financing and that no more subsidy is provided than is necessary for a business expansion to be undertaken.

To some extent, these issues are being considered. We believe they need more thorough review and consistent application across programs. In particular:

- DEED and the Minnesota Energy and Economic Development Authority (MEEDA) should change the standard practice of providing below-market-rate financing to all firms receiving Minnesota Fund loans.

- DEED and MEEDA should not use the Small Business Development Loan Program for business projects that would be undertaken in Minnesota with private financing.

DEED should also consider whether below-market-rate financing is necessary for all businesses receiving loans financed by the Economic Recovery Fund.

The department plans to implement two additional loan programs: one for small software development companies and another for small tourism businesses. In addition, the department is proposing a product development loan program to finance the development of product prototypes. We think that the software development and product development loan programs need to be reviewed more carefully by department staff outside of the technology offices, particularly the Policy Analysis Division and the Financial Management Division, before being implemented. The experience of other states that have operated similar programs should be considered in light of the riskiness of these loans. It is unclear whether the proposed tourism loan program is the best available use of monies in the Economic Development Fund. If implemented, however, we believe it should be targeted to economically distressed areas of the state and to tourism facility improvements that would not take place without state loan participation.

2. TOURISM PROMOTION

The department's expanded tourism promotion efforts appear to have been generally successful in stimulating the state's economy, although not as successful as program advocates suggested. Our best estimate is that the additional state expenditures on promotion and advertising are generating, on average, at least $5 in additional tourism spending per tax dollar spent. However, some of the expanded efforts have yet to generate benefits much greater than their costs. In particular:

- The 1984 television advertising campaign conducted in out-of-state markets does not appear to have been very effective. Initial data on the inquiries generated by the campaign and its impact on Minnesota's share of the out-of-state vacation market are not encouraging.

However, it is too early to conclude that television advertising outside Minnesota cannot be effective. The tourism office experienced several problems in implementing the first year of the advertising campaign and is taking steps to correct those problems during this year's campaign. In addition, it may take repeated exposure to television to change the vacation choices of non-Minnesota residents. The effectiveness of the 1985 television campaign needs to be closely monitored to ensure that future promotional expenditures are targeted to those markets and media that bring the highest return.

We also recommend that the Minnesota Office of Tourism develop a methodology for estimating the return on investment for major advertising campaigns, particularly those conducted outside Minnesota. The office has in place some of the studies and surveys needed to estimate the return that the state is receiving for its tax dollars. However, the office needs to combine survey results with a methodology similar to but more extensive than the one we used in this report. We believe it is important to know which of the various expanded tourism promotional efforts have been worth their cost.

3. ECONOMIC DEVELOPMENT MARKETING

The department needs to better target the economic development marketing program that began last year. We recommend that:

- Advertisements in general circulation newspapers in Minnesota, while they may have served a purpose in initiating the program, should not be used in subsequent years.

- The department's advertising campaign should be targeted to business executives in Minnesota and elsewhere who could potentially be persuaded to locate, expand, or retain a business in Minnesota.

- The program should become more proactive and attempt to identify firms that are: 1) considering a move out of Minnesota, 2) considering expanding outside of Minnesota, and 3) considering various sites here and elsewhere for a business start-up or expansion.

There are indications that the department has recently begun to move its marketing program in this direction. The Marketing Office began a telemarketing campaign within Minnesota in January. Among the purposes of the campaign is the identification of Minnesota businesses with specific expansion or relocation plans and any problems those businesses may have with staying or expanding in Minnesota. In addition, within the last several weeks, the new director of marketing began to draft a marketing plan for the 1986-87 biennium. Although the initial draft plan does not provide a specific breakdown of advertising expenditures, it seems to reflect most of our concerns about targeting. In particular, the draft plan indicates that advertisements in general circulation newspapers will be greatly reduced and used only where deemed appropriate in order to fill gaps in demographic coverage.

4. LEGISLATIVE RECOMMENDATIONS

The Legislature needs to reexamine some of the programs established or expanded in the last two years. These include the various business tax credits enacted over the last two years. We recommend that:

- The Legislature should not appropriate any additional funds for competitive city enterprise zones or grant tax credits to specific companies through legislation. The Legislature should instead consider establishing an "economic opportunity zone" program so that credits can be better targeted for use in attracting significant business expansions and start-ups, particularly for communities with high unemployment rates.

- The Legislature should reassess whether the equity investment credit is the best available use of state funds for economic development purposes. If the credit is retained, eligibility should be more restricted.

- The Legislature should consider not renewing the small business assistance office credit. If it can be demonstrated that public funds for small business assistance offices are needed and would result in significant economic benefits for the state, funding should instead be provided through an appropriation to DEED for a grant program.

We also recommend that:

- The Legislature should change the Economic Recovery Fund Program so that, in the future, the entire amount loaned to a business will be repaid to the state. This change will help ensure that future uses of repaid loans are properly targeted and that more cities can benefit from the program.

- The Legislature should consider phasing out state planning grants for community development corporations. The Legislature should also consider whether venture capital grants to community development corporations have been a productive use of economic development resources after this year's grant recipients are selected by DEED. At a minimum, the Legislature should consider requiring that grants loaned to private businesses be repaid to the state so that future uses of repaid loans are properly targeted.

5. RESEARCH

Finally, DEED should continue the research its Policy Analysis Division has begun on the Minnesota economy. The division's research will hopefully be useful both in designing and targeting economic development programs and in recognizing the limitations to providing financial incentives to certain sectors of the economy and types of businesses. We believe that the division's research may be helpful in guiding state policies in areas such as taxation and education as well as economic development programs.

B. IRON RANGE RESOURCES AND REHABILITATION BOARD

The continuing severity of the economic recession on Minnesota's Iron Range has caused the Iron Range Resources and Rehabilitation Board to rather quickly shift its focus to that of an economic development agency. Like DEED, it has faced the difficult task of implementing development programs in a short period of time. The IRRRB has also faced the additional task of attempting to quickly create new jobs to replace the estimated 10,000 jobs that have been permanently lost in the region.

In general, we find that the IRRRB has identified in its economic development plan appropriate sectors of the economy in which opportunities for economic development exist. These include tourism, timber and wood products, alternative energy, new mining technologies, and manufacturing and other businesses that diversify the economy. The sectors identified by the IRRRB are generally similar to those identified by the Northeast Minnesota Task Force at the University of Minnesota.

In addition, the IRRRB has funded a number of worthwhile projects. For example, the IRRRB was successful in getting a large company to build a waferboard plant near Two Harbors, using industrial revenue bonds to finance plant construction costs and an interest buy-down on an equipment loan. This company will employ about 100 workers at the new plant. The IRRRB has also financed a number of research projects that may stimulate future growth. These include the plasma-smelt and coal reduction projects, peat research, and wood products industrial park studies. We support the IRRRB's current efforts in each of these areas, although they may not all ultimately create jobs. Finally, the IRRRB has undertaken a number of smaller tourism-related projects that have potential to stimulate the area economy.

However, the IRRRB has not done an adequate job of analyzing some of the projects that have been funded, particularly some of its largest projects. For example:

- The IRRRB has not adequately examined and compared the benefits and costs of the Iron Range Interpretative Center expansion.

- The IRRRB did not adequately analyze the benefits and costs of developing the Giants Ridge ski area.

- In making business loans, the IRRRB has not adequately considered: 1) whether a proposed business project would have been undertaken without a public subsidy, 2) how much subsidy is needed for a project to be undertaken, 3) what effects a proposed business expansion will have on competing businesses on the Iron Range, and 4) whether a business applying for a loan is dependent on the local economy.

1. IRON RANGE INTERPRETATIVE CENTER

We doubt whether an expanded interpretative center operation can draw a sufficient number of additional tourists to justify its capital and additional operating costs. We recommend that:

- The IRRRB should halt plans to construct the science museum, the historic village and railroad, and the golf course and other amenities for the proposed hotel development. An independent consulting firm that is experienced in market analysis should be hired to analyze the tourism potential of the interpretative center expansion. The consultant should compare the capital and operating costs of the expansion to the estimated benefits from additional tourism.

- The consultant should focus first on the railroad. It is necessary to review whether the railroad without other planned development can generate sufficient benefits to justify its capital and operating costs since a decision must be made soon in order to avoid digging up the center's grounds a second time.

- No additional development should occur unless the expected benefits (including additional tourism revenues for the Iron Range area and operating revenues for the interpretative center) less the additional operating costs are sufficient to pay back the capital costs of development over a reasonable period of time.

- The choice of a consulting firm should be approved by a non-partisan panel of state officials and citizens. For example, IRRRB management could convene a panel consisting of university experts in tourism promotion, the director of the Minnesota Office of Tourism, the director of the Minnesota Historical Society, the Legislative Auditor, and others.

IRRRB management has indicated to us that they do not believe it is necessary for additional development to generate benefits sufficient to pay back its capital costs. They claim that development is justified if it reduces the interpretative center's operating deficit. We believe that a project should not be undertaken unless: 1) its net annual benefits are sufficient to pay back its capital costs over a reasonable period of time, and 2) other economic development projects have less favorable rates of return. For example, if a $10 million project would generate only $500,000 in annual net benefits, it should not be undertaken. The project would take more than 20 years to pay for itself, when the value of benefits received over time are properly discounted.

Even if the consulting firm determines that the proposed expansion or parts of it are worthwhile, we believe that it would be better to wait until after the center's 1986 summer season before going ahead with additional expansion other than the railroad. At that time, IRRRB management would be in a better position to judge the desirability of additional expansion. The amphitheater would have been operating for one summer season and attendance figures for that season would be available.

Even without any additional expansion, we believe that IRRRB management can make more effective use of the existing facility and its new amphitheater. In particular, we recommend that:

- The IRRRB should continue to expand successful events such as ethnic days and attract other potentially successful events such as the polkafest. The new outdoor amphitheater should help in attracting other events.

- The IRRRB should raise admission prices, particularly during special events featuring live entertainment.

In addition, IRRRB management should, when the center reopens, conduct a systematic survey of its visitors. Survey data would help management determine which special events are drawing tourists to the Iron Range and enable management to make informed decisions about the relative benefits of various events.

It should also be noted that the IRRRB is undertaking similar development of interpretative facilities elsewhere on the Iron Range. The IRRRB is spending $350,000 for development at the Hill-Annex Mine in Calumet and is considering the construction of an interpretative center at the Croft Mine. The IRRRB has applied for a federal grant to fund 75 percent of the estimated $1.5 million cost of constructing an interpretative center at the site of the Croft Mine. This center would focus on the history of the Cuyuna Range.

Our concerns about the desirability of the expansion of the Iron Range Interpretative Center also apply to these two projects. Without the federal grant, the Croft Mine project would be a very questionable expenditure of funds. Even with the federal grant, we wonder whether the center would generate enough interest to justify its costs. Before any more interpretative centers or similar developments are funded, IRRRB should have an independent consulting firm thoroughly review the benefits and costs.

2. GIANTS RIDGE SKI AREA

It is not clear at this time whether the Giants Ridge ski area will prove to have been a wise risk for the IRRRB to take. The answer depends a great deal on the degree to which the IRRRB can attract training athletes and major ski competitions that would not have otherwise occurred in Minnesota. Given that the ski facility and winter training facilities have been built, the best course of action is for IRRRB management to attract more winter athletes and major events that will draw tourists who would not have otherwise come to northeast Minnesota.

However, any major new construction, particularly that being considered for summer training and recreational activities, should be carefully reviewed before being undertaken. We recommend that:

- Before the IRRRB proceeds with any additional major development at Giants Ridge, the IRRRB should hire an experienced, independent consulting firm to thoroughly analyze the economic return on each major component of any expansion plans. The firm should consider both the capital and operating costs as well as the operating revenues and spending in nearby communities. Furthermore, it should consider whether any new facility would compete with other facilities in the region and state.

3. BANK PARTICIPATION LOAN PROGRAM

Many of the questions raised about the effectiveness of IRRRB's loan program are not unique to the IRRRB. Many development agencies are subject to similar criticisms. However, we believe that it is in the best interests of IRRRB and other agencies to modify their project review process. In the case of the Iron Range, it is imperative that public subsidies be used wisely and be targeted to those projects that create the most jobs and would not be undertaken without subsidy from IRRRB.

We recommend that:

- IRRRB staff should revise their approach to loan review. In addition to reviewing the financial feasibility of a project, the review should consider: 1) whether the project would have been undertaken without the subsidy, 2) how much public subsidy is necessary for the project to be undertaken, 3) what effects the project will have on competing businesses on the Iron Range, and 4) whether the project is for a business that is dependent on local economy.

- The board's Technical Advisory Committee (TAC) should focus its review on these four issues, as well as the financial feasibility of a project. To facilitate this review, the TAC should be expanded to include additional members with expertise in economic analysis.

Based on their experience over the last two years, IRRRB management believes that its loan program needs to undergo some additional changes. Management now believes that a bank participation loan program may not be the best way to stimulate economic growth. The program attracts a number of loan applicants whose projects would likely proceed with private financing. The modest subsidy provided by the IRRRB's participation in the loan is not needed in such cases.

IRRRB management thinks the loan program should become involved with development projects in which its participation is more essential. Management would like to begin participating in some subordinated lending in which the IRRRB would no longer share first position with a bank. It is argued that the loan program can be more effective if it provides a subsidy to a project that is marginal rather than to a project that is able to receive private financing and proceed without a subsidy.

We generally agree with management's position. However, we are concerned that the IRRRB currently has few staff with the experience and training necessary to evaluate the financial and economic potential of proposed loans, particularly more risky loans. Provided that the IRRRB obtains the needed staff resources, we would support the IRRRB's making a limited number of such loans on a pilot program basis. The IRRRB should review the results of an initial pilot effort before committing substantial resources to a subordinated lending program.

4. OTHER CONCERNS

In the future, we recommend that:

- IRRRB management should focus more of its attention on attracting larger business expansions from businesses outside the Iron Range, particularly businesses outside the state.

We realize that it is difficult to attract businesses from elsewhere. IRRRB's job will not be easy. Northeastern Minnesota's distance from product markets may not work in its favor. However, if a significant number of the 10,000 lost jobs are to be replaced, the IRRRB will need to pursue expansions by larger businesses.

We also recommend that:

- The IRRRB should hire a minimum of two additional staff whose training and experience enable them to evalute the benefits and costs of proposed development projects.

As we have noted, the IRRRB has remarkably few staff to review potential development projects. Hiring several staff would free some of the business development administrator's time for pursuing larger business expansions. In addition, the new staff can provide IRRRB management and the board with a more effective review of proposed tourism projects and ongoing oversight of its tourism promotion and other existing programs.

Finally, there is the question of whether ongoing oversight of the IRRRB is needed beyond that provided by the Legislative Advisory Commission and the Governor. In July 1982, when the board first gained access to the NEPF, a trust fund board was created. That board had to approve any spending from the NEPF before the IRRRB could use NEPF monies for economic development projects. In April 1983, the Legislature abolished the trust fund board. Iron Range legislators said that the trust fund board was not needed and that it delayed the process of getting development projects started on the depressed Iron Range.

We believe that greater review of major IRRRB ventures such as the interpretative center expansion and the Giants Ridge development prior to the commitment of funds is desirable. Without any law change, the Legislative Advisory Commission could serve as a vehicle for more effective oversight of IRRRB projects. Currently, all projects funded through either the TEPF or the NEPF must be reviewed by the commission. The commission's recommendation is, however, advisory and final approval is up to the Governor. Nevertheless, the commission could put pressure on the IRRRB to undertake market analyses of major projects as we have recommended.

We have also recommended that the IRRRB expand the Technical Advisory Committee used to review proposed business loans. An expanded committee could also assist IRRRB staff in reviewing other proposed business ventures not involving the loan program.

Economic Development Programs in Minnesota

Chapter 1

In the last two years, the number of and expenditures for economic development programs have increased dramatically in Minnesota. This chapter briefly lists the new and expanded programs administered at the state level by the Department of Energy and Economic Development and in northeastern Minnesota by the Iron Range Resources and Rehabilitation Board and provides a framework for our analysis. In subsequent chapters, we examine whether and how these programs can be effective in stimulating economic growth and creating and retaining jobs.

A. BACKGROUND

In response to a severe economic recession and increased competition among states for new business development, the Governor recommended and the 1983 and 1984 Legislatures enacted a wide variety of new economic development programs and significantly expanded several existing programs. Major commitments to economic development at the state level include:

- $35.6 million for an enterprise zone program that provides tax incentives to businesses in distressed areas;
- $15 million for an Economic Development Fund to provide loans to new and expanding businesses;
- a $6.1 million increase in the Office of Tourism's biennial budget for use in attracting additional tourists to Minnesota;
- $6 million for an Economic Recovery Fund to provide grants to cities for economic development projects;
- $6 million to help develop a Technology Corridor in the city of Minneapolis;

- $1.1 million for an economic development marketing program; and

- three new tax credits to encourage investment in and development of small businesses.

In addition, the 1983 Legislature split the existing Department of Energy, Planning, and Development into a new Department of Energy and Economic Development (DEED) and the State Planning Agency. DEED was given responsibility for administering these new economic development programs. The number of staff involved in economic development also increased sharply.

In the last several years, economic development has also increasingly become the major focus of the Iron Range Resources and Rehabilitation Board (IRRRB). Although a state agency, the IRRRB has a regional rather than statewide focus and relies on funding from taconite production taxes levied on area mining companies in lieu of local property taxes rather than the state's General Fund. Due to the severe decline of the taconite mining industry in recent years, the Legislature has permitted the IRRRB to use money from the Northeast Minnesota Economic Protection Trust Fund which originally was not to be spent until the year 2002. Through FY 1984, the IRRRB has received more than $30 million from the fund. With these and other monies, the IRRRB has committed significant resources to economic and tourism development projects, including:

- $8.5 million for expanding the Iron Range Interpretative Center;

- $6.9 million for developing the Giants Ridge ski area;

- more than $5 million in loans to Iron Range businesses and resorts;

- $5 million for a common bond reserve fund to secure industrial revenue bonds issued by the IRRRB;

- approximately $4.9 million in grants and loans to Iron Range school districts and other public agencies to convert boilers to burn wood or peat;

- $1.6 million for research on the economic feasibility of producing peat in northeastern Minnesota; and

- approximately $1.4 million to help develop a demonstration facility for producing steel and pig iron from taconite using plasma-smelt technology.

B. ISSUES

Clearly, economic development has become a priority in Minnesota. However, Minnesota is not alone in initiating a greatly expanded economic development agenda. The recessions that adversely affected the nation's economy in the early 1980's caused many states to increase the amount of spending for programs designed to stimulate economic growth. As a result, states have become increasingly competitive with each other in seeking to attract new or expanded businesses and tourists.

Despite this increased competition, we are somewhat skeptical that any economic development program can have a significant impact on the state's economy. National and international economic factors, state and local taxes, education, and production and transportation costs undoubtedly have far more impact on the state's economy than economic development programs.

Even though they are not major factors, economic development programs may have some marginal impact on economic activity within the state. Just how much impact such programs can have, compared to these other factors, is difficult to measure. Consequently, we have not attempted to measure and compare the relative impact of development programs to tax reductions, educational reforms, more highway construction and maintenance, or other functions of state government that can influence economic growth.

Instead, this report focuses on whether economic development programs have been designed and administered so that the state obtains the maximum benefits possible. In our view, the potential impact of such programs is greater if the programs are directed at the types of businesses and economic sectors that are most likely to create net jobs if financial incentives are provided or promotional activities increased. For example, financial incentives to retail businesses are much less likely to create jobs than those directed to manufacturing businesses. If one retail business expands because of a public subsidy, it is likely that other retail competitors will be negatively impacted. The result would likely be that employment at the subsidized firm increases while employment at competing retail firms declines, thus resulting in no net change in the number of jobs in the area economy. The public subsidy simply shifts retail spending and employment to the subsidized firm from others.

A financial incentive to a manufacturing firm has more potential for job creation but is by no means a guarantee that there will be a net increase in jobs for the state. A subsidized manufacturing firm is most likely to create jobs for the state if the firm is selling its products nationwide and has no Minnesota competitors. Then, its expansion would come at the expense of competing firms in other states. If the firm is selling its products within the state and has many other Minnesota competitors, then its expansion might come at the expense of other Minnesota firms.

Economic development programs can also be more effective if they are not used to subsidize business projects that would occur with private financing. Sometimes development agencies simply assume that if an expanding business is given public financing, then the jobs the business adds were created as a result of the economic development program used to subsidize the expansion. Of course, if the project could have been financed without public funds and would have been undertaken anyway, the jobs created are not the result of an economic development program.

We think it is likely that Minnesota and other states will continue to have economic development programs because of the continuing tough economic times for certain economic sectors and the climate of increased competition for jobs among states. As a result, we believe it is important to focus on the effectiveness of economic development programs even if their job creation potential cannot be easily compared to that of other policies and programs that state government can change. Minnesota can benefit more if its economic development programs are well designed and administered than if they are not.

Department of Energy and Economic Development

Part One

Introduction
Chapter 2

The Minnesota Department of Energy and Economic Development (DEED) is responsible for implementing many of the state's economic development programs. This chapter describes the Department of Energy and Economic Development, presents an overview of its budget, and introduces the economic development programs it administers. Subsequent chapters will describe each program in some detail, evaluate their effectiveness in stimulating economic development, and recommend changes for improvement.

A. ORGANIZATION AND BUDGET

Minnesota's commitment to economic development increased significantly in 1983 when, in response to difficult economic conditions and increased competition among the states for new business development, the Legislature greatly increased the amount of state resources available for economic development at the Governor's request. The Legislature also split the existing Department of Energy, Planning, and Development into two agencies: The Department of Energy and Economic Development and the State Planning Agency. These actions raised the visibility of the state's development efforts.

As shown on Figure 2.1, DEED is organized into eight divisions: Energy, Economic Development, Tourism, Financial Management, Community Development, Science and Technology, Policy Analysis, and Administration. Staffing for the department is currently at 248.5 positions, an increase of about 92 positions over FY 1983. Approximately 190 of the 248.5 positions are funded by the state's general fund. About 100 state-funded positions are staff directly or indirectly involved in the department's economic development functions.

Minnesota's increased commitment to economic development is shown on Table 2.1. Energy and economic development expenditures (excluding federal and rural rehabilitation funding) rose from $8.1 million in FY 1983 to $13.0 million in FY 1984, an increase of 61 percent. DEED's expenditures for FY 1985 are estimated at $60.7 million, a seven-fold increase over FY 1983. Economic development expenditures alone, excluding new tax credits, have increased more than nine-fold between FY 1983 and FY 1985. New economic development and energy programs account for much of the funding increase, with the remainder attributable to staffing increases and expanded use of economic development programs existing prior to 1983.

B. ECONOMIC DEVELOPMENT PROGRAMS

DEED administers four types of economic development programs: financial incentive programs, tax credits, assistance and information programs, and promotion programs. The particular programs of each type are briefly discussed below.

1. FINANCIAL INCENTIVE PROGRAMS

Central to many of the state's financial incentive programs is a $15 million Economic Development Fund. Actual and planned uses of the fund include:

- the Minnesota Fund Program, which may finance 20 percent of a business project's cost up to $250,000;
- the Small Business Development Loan Program, which provides subsidized, fixed-rate loans to small businesses by issuing tax-exempt bonds guaranteed in part by monies from the Economic Development Fund;
- the Special Assistance Program, which can provide direct loans, loan guarantees, and other forms of assistance to businesses that have significant impact on the state and local economies;
- a proposed software development loan program, which would loan funds to small businesses that develop and produce computer software; and
- a proposed tourism loan program, which would provide loans to small tourism businesses.

DEED is authorized to use the Economic Development Fund for several other programs which have not yet been developed, including loans for business projects that involve hazardous waste recycling, waste tire processing, pollution control, and farming. Table 2.2 contains a summary of DEED's actual and

TABLE 2.2

ECONOMIC DEVELOPMENT FUND*

Sources of Funds		Unencumbered Balance	$8,634,815
Appropriation to Economic Development Fund (FY 1984 and FY 1985)	$15,000,000	DEED's Suggested Uses of Unencumbered Balance	
Interest Earned on Fund Balance	1,338,552	Tourism Loans	2,000,000
		Special Assistance Program Loan Guarantees	
Total Funds Available	$16,338,552	Computer Chip Manufacturer	2,500,000
		Farm Equipment Manufacturer	750,000
Uses of Funds		Special Assistance Program (user unknown for vacant glass manufacturing plant)	1,000,000
Net Expenditures for Loan Programs		Courseware Product Development Loans	250,000
Minnesota Fund Loans	$ 2,004,737		
Small Business Development Loan Guarantees	4,920,000	Total Suggested Uses of Unencumbered Balance	$6,500,000
Minnesota Plan Guarantee	125,000		
Special Assistance Loan Guarantee	300,000		
Test Case Expenditures	250,000		
Program Development Costs			
Small Business Development Loan Program	88,000		
Courseware Product Development Loan Program	16,000		
Total Expenditures	$ 7,703,737		
Unencumbered Balance	$ 8,634,815	Non-Directed Balance	$2,134,815

Source: DEED, Financial Management Division.

*As of February 22, 1985.

2. TAX INCENTIVE PROGRAMS

The 1983 Legislature established two economic development programs based on tax incentives. First, the enterprise zone program provides for the designation of distressed areas in which special tax credits are available to businesses. Up to $35.6 million in foregone tax revenues may be distributed to qualified businesses in designated enterprise zones over an eight-year period. About $16.6 million has been allocated for border city zones and $19 million for competitive city zones. The commissioner of DEED is responsible for designating enterprise zone areas. DEED has little control over which businesses eventually receive the credits since the local governments with designated zones may distribute the credits to any eligible business project. However, the commissioner must disapprove of any business that has been "pirated" by an enterprise zone city from another city.

The second tax credit program is the Small Business Investment Credits Program. Persons or corporations may receive income tax credits for investing in a qualified small business. Corporations may receive tax credits for transferring a technological process to a qualified small business. Corporations and banks may receive credits for contributions to a qualified small business assistance office. DEED staff certify small businesses and assistance offices as being eligible for the program. The basic criteria for determining eligibility are established in statute, leaving DEED with little discretion in determining which businesses or assistance offices qualify for the credits.

To evaluate these tax credit programs, we asked:

- Are tax credits a cost-effective way to stimulate economic development?

- Are these programs targeted to business projects that will result in net economic growth?

Chapter 6 presents our analysis of these tax credit programs.

3. ASSISTANCE AND INFORMATION PROGRAMS

Supplementing the financial incentives and tax credit programs are DEED's assistance and information programs. The Economic Development Division administers several programs to assist both businesses and local development agencies. For example, businesses may obtain assistance and a variety of information through DEED's Business Information Program. Local development staff may improve their skills in economic development through the Star Cities Program or through a specialized training program in business finance. These programs are discussed in Chapter 9.

4. PROMOTION PROGRAMS

In the last two years, there has been a significant increase in activities designed to promote the state. The most signficant increase in expenditures has been for tourism promotion to attract vacationers to Minnesota. The budget of the Minnesota Office of Tourism increased from $2.4 million in the 1982-83 biennium to $8.5 million in the 1984-85 biennium. It is believed that with increased awareness about Minnesota as a vacation area, more Minnesotans will vacation in the state and more tourists from other states and countries will be attracted to Minnesota, thus stimulating economic activity for tourism-related businesses.

Minnesota also promotes itself in a more general way through an economic development marketing program developed and administered by DEED's Economic Development Division. Established by the Legislature in 1984, the marketing program attempts to encourage business retention and expansion through an advertising campaign and other promotional activities. This program received an appropriation of $1.1 million for FY 1985, of which $200,000 is contingent upon a matching private sector contribution.

In reviewing these efforts, we asked:

- How successful are promotional activities in stimulating economic activity?
- How much benefit is the state receiving from its investment in promotion?
- Are the programs targeted to audiences that are likely to be influenced to consider Minnesota in their vacation or business plans?

These questions are considered in Chapter 6 on tourism promotion and Chapter 9 on the economic development marketing program.

Loan and Loan Guarantee Programs

Chapter 3

In this chapter we evaluate business loan and loan guarantee programs operated by the Department of Energy and Economic Development (DEED). These programs attempt to create or retain jobs by providing financial incentives to Minnesota businesses that are expanding or contemplating a move to another state, and to non-Minnesota businesses considering a move to or expansion in Minnesota.

In the first section, we evaluate the three major business loan and loan guarantee programs administered by DEED: the Small Business Development Loan Program, the Minnesota Fund Program, and the Special Assistance Program. The second section examines three other programs: a state farm loan program, the OMNI Program, and the Minnesota Plan.

Our analysis is directed at the following issues:

- Are these programs well designed?
- How well are the programs targeted toward the types of businesses that are likely to create jobs for Minnesotans?
- How successful are the programs in creating jobs?
- Does DEED have the economic analysis capability it needs to make these programs successful?

A proposed tourism loan program is discussed in Chapter 6. A loan program for small software development companies and a proposed technology development loan program are discussed in Chapter 7.

A. MAJOR STATE PROGRAMS

1. PROGRAM DESCRIPTION

DEED administers three major business development loan programs: the Small Business Development Loan Program, the Minnesota Fund Program, and the Special Assistance Program. The Legislature made a significant commitment to small businesses by restricting the first two programs to small firms. Larger companies can receive assistance through the Special Assistance Program. The Minnesota Energy and Economic Development Authority (MEEDA), which is made up of members from the banking, investment, business, and labor communities, selects loan recipients for each program based on analyses and criteria developed by DEED's Financial Management Division.

The Small Business Development Loan Program provides fixed rate, low interest loans for expansion and renovation projects by small businesses. The intent is to help small businesses create or retain jobs in Minnesota. The program is available to proprietorships, partnerships, or corporations which satisfy the federal Small Business Administration's definition of a small business. Funds for these loans, which range from $250,000 to $1 million, are raised by issuing industrial revenue bonds. The loans can be used for land, buildings, and equipment, but not for working capital. The loans can cover up to 80 percent of total costs of land and buildings and up to 75 percent of equipment and machinery costs. The remaining portion is covered by an equity contribution by owners. Banks and other traditional fund sources do not participate in these loans, although they could be involved in financing other aspects of the project. Whenever possible, loans are secured by a first mortgage on real property and a first lien on equipment. Maximum term is 20 years for land and buildings and 10 years for machinery.

DEED attempts to keep the interest rate under this program as low as possible. Tax exempt bonds are the source of financing, and steps are taken to reduce risk to bondholders. First, using some of the funds raised through each bond issue, DEED sets up a debt service reserve account. The amount is sufficient to cover one year's debt service. If a company misses payments the fund would be tapped to pay bondholders. Second, an amount equal to 25 percent of the bond principal is shifted from the Economic Development Fund into a pooled guarantee account. In the event of a default the entire guarantee account is available to stand behind each project. It is quite unlikely that a bondholder would lose money. The collateral for the loan, the debt service reserve, and the entire guarantee account should fully compensate the bondholder. Table 3.1 lists the firms that have received Small Business Development loans.

Like the Small Business Development Loan Program, Minnesota Fund loans can be used by small businesses for land, buildings, and

TABLE 3.1

SMALL BUSINESS DEVELOPMENT LOANS

Name of Business	Location	Project Description	Dollar Amount	Job Claims
Big Stone	Arlington	Pollution control project and purchasing freezing equipment for a manufacturer of canned vegetables and fruit drinks.	$ 584,000	62 retained 18 created
Award Craft	Bloomington	Plant and equipment loan for manufacture of awards, trophies.	1,025,000	27 retained 42 created
ERCOA	Braham	Land, building, equipment loan for a manufacturer of pontoon boats.	1,200,000	22 retained 22 created
Englund Graphics	New Hope	Plant expansion and equipment for a manufacturer of business forms for the micro computer industry.	550,000	30 retained 15 created
Computer Controlled Machines	Northfield	Land and building loan to manufacture computer assisted food processing machinery.	1,000,000	42 retained 26 retained
Metro Mold & Design	Rogers	Land and building loan for a maker of plastic injection molds.	315,000	6 retained 8 created
J & B Distributing	St. Michael	Expansion of warehouse and cold storage for a meat, seafood distributor.	1,220,000	25 retained 32 created
Chas. A. Bernick, Inc.	Waite Park	Construct building, add equipment to expand capacity of a soft drink bottler.	650,000	18 retained 11 created

Source: DEED.

Name of Business	Location	Project Description	Dollar Amount Total	Private	Public	Job Claims
Nordic Boat Company	Little Falls	To purchase and renovate plant, produce recreational boats.	825,000	740,000	85,000	46 retained 34 created
Diamond Clear Ice	Marshall	Finance equipment, expansion of an ice company.	555,000	444,000	111,000	14 retained 12 created
IDA	Moorhead	Financing renovation and expansion by a maker of telephone equipment.	800,000	640,000	160,000	19 retained 11 created
Roffe Container	Moorhead	Buy and renovate building to make plastic containers.	220,000	180,000	40,000	15 retained 26 created
S.B. Foot Tanning	Red Wing	Install new leather drying equipment.	500,000	400,000	100,000	285 retained 0 created
McCourtney Plastics	Staples	Expand and install equipment to make plastic injection molds.	1,584,000	1,334,000	250,000	33 retained 32 created
Pine County, Inc.	Staples	To buy abandoned plant, renovate, and produce clothing.	275,000	220,000	55,000	30 retained 36 created
Rivard Quality Seeds	Argyle	To rebuild agricultural processing and storage facility.	837,881	663,102	174,776	2 retained 12 created

Source: DEED.

*$250,000 Minnesota Fund, $250,000 Economic Recovery Fund.

rate flexibility helps keep Minnesota competitive with other states in its efforts to attract or retain businesses.

The Special Assistance Program is a new program intended to assist businesses that have a significant impact on the local or state economy. The program provides assistance to large or other companies that do not qualify under other programs or which could not receive an adequate level of assistance.

The Special Assistance program can provide fixed-rate, low interest loans through issuing industrial revenue bonds, which can be backed by a guarantee account using money from the Economic Development Fund. Used in this way it is similar to the Small Business Development Loan Program, except that the Special Assistance Program will handle loans exceeding $1 million. There is no maximum loan amount specified in statute or rule other than the restriction that only $10 million in total bonding authority is available for this program. However, DEED has an internal limit of $3 million on each loan.

The Special Assistance Program can also provide guarantees for loans made by other parties, and it can be used for working capital, which cannot be financed under the Minnesota Fund or Small Business Development Loan programs. Finally, MEEDA can purchase loan packages from other financial institutions under this program.

Thus far, only one company has received assistance through this program. The company received a working capital loan guarantee. Several loans and loan guarantees are pending. While there has been little activity, the program is significant due to the potential magnitude of each transaction.

To be eligible for the program a business must meet at least three of the following five criteria:

- Special assistance will enable a business not currently located in Minnesota to locate a facility within Minnesota which increases the number of jobs within the state.
- In order to expand or remain in Minnesota, the business has demonstrated that it is unable to obtain suitable financing from other sources.
- The business will create or retain significant numbers of jobs within a community in Minnesota.
- The business has a significant potential for growth in jobs or economic activity within Minnesota within the ensuing five-year period.

- The business will maintain a significant level of productivity in Minnesota within the ensuing five-year period.

2. PROGRAM ANALYSIS

Since the Special Assistance Program was only recently used for the first time, our analysis of loans approved by MEEDA is limited to the Small Business Development Loan Program and the Minnesota Fund Program. As a result, the bulk of this section examines loans made under these latter two programs and recommends some changes in the analysis of loan applications and in the policies underlying the programs. A brief concluding section reviews the Special Assistance Program and suggests some future directions for the program.

a. Minnesota Fund and Small Business Development Loan Programs

We believe that DEED management and MEEDA have generally done a good job in operating the Minnesota Fund Program and the Small Business Development Loan Program. Loans have been targeted to manufacturing businesses, which we agree are more likely to need assistance in order to expand in or move to Minnesota. This targeting decision makes it more likely that loans from the programs will result in net job creation and economic growth for Minnesota.

However, we believe that a number of changes need to be made in the design and operation of these two programs in order to enhance DEED's ability to create and retain jobs. Our analysis of these programs and the recommended changes are discussed below.

Loan Selection Criteria

DEED and MEEDA are permitted considerable latitude in selecting firms to receive loans under these programs. Based on DEED's rules, any firm meeting *at least one* of the following criteria is eligible to apply for a Small Business Development loan or a Minnesota Fund loan:

a. The applicant is located in an area of the state that is experiencing severe unemployment.

b. The applicant is located in a border community that experiences a competitive disadvantage due to location and with this financial assistance the applicant would be induced to stay in Minnesota rather than to move.

c. The applicant is likely to expand within the state and to create additional taxable property to local units of government.

d. This financial assistance will help induce the applicant to locate in an area of economic distress or to provide jobs that would not otherwise be available to that area without the inducement of this financial assistance.

e. This financial assistance will create or maintain sufficient numbers and types of jobs to justify participation in the financial assistance programs.

f. Energy sources and public facilities will be sufficient to support the successful operation of the project.

g. If the financial assistance shall have the effect of a transfer of employment from one area of the state to another, the authority shall determine that the project is economically advantageous to the state or that the project is necessary to the continued operation of the business enterprise within the state.

Since an acceptable project needs to meet only one of the above requirements, these criteria provide DEED and MEEDA with considerable flexibility in selecting loan recipients. In fact, it is difficult to envision a project that could not qualify.

By themselves, these criteria do not adequately capture the underlying financial and economic justifications for giving assistance to specific firms. For example, any firm moving into the state or expanding within the state would be able to qualify under criterion "c", but clearly few should receive assistance given reasonable economic development goals. Similarly, adequate energy sources and public infrastructure must be available for a successful plant expansion, but MEEDA would never fund a project simply because the infrastructure is adequate. Thus while criterion "f" must be met to permit a successful expansion or relocation, it is not a justification for financing a project. Finally, using criterion "a" firms located in an area of the state with severe unemployment could receive low interest loans. However, little is accomplished if the state assists firms in that geographic area without considering each firm's access to private capital and the degree to which each firm may be dependent on the depressed local economy for an adequate demand for its products. Clearly, DEED and MEEDA are going beyond these selection criteria and are using more stingent financial and economic guidelines to select loan recipients.

DEED and MEEDA should maintain a high degree of flexibility. Selection guidelines in rule can never substitute for the professional judgements needed from DEED and MEEDA. The criteria must permit these groups to respond to unforeseen opportunities. However, we recommend that:

- DEED's rules should by amended to better reflect the underlying financial and economic reasoning actually used to select firms for these programs.

If firms must meet more than one criterion to be actively considered for a loan, or if certain combinations of criteria must be satisfied, this should be stated. If some of the existing criteria are not relevant, they should be deleted.

We noted earlier that MEEDA and the Financial Management Division have decided to limit these programs almost exclusively to manufacturing firms. DEED staff argue that such businesses can provide a stronger impact on jobs and economic activity than funding restaurants or retail and lodging establishments. The latter are generally dependent on the local economy and by themselves cannot stimulate a depressed area. We agree with this policy. It is a significant step in effectively targeting these programs for economic development. However, DEED's restrictions should be formalized in rule so that the public and potential applicants are aware of the decision.

Success In Job Creation

The basic intent of these programs is to create net jobs--increases in Minnesota employment. To be successful, DEED and MEEDA should avoid funding firms with significant competition within Minnesota. There is a risk that the expansion of one firm will cause a loss of jobs in competing firms. Second, with the possible exception of special incentive financing to retain or attract a firm, DEED and MEEDA should avoid funding projects which the private sector would undertake anyway. Funding these projects creates no net gain in jobs since the jobs would occur without state involvement.

In reviewing the files and interviewing staff we found that DEED does not have procedures to fully consider the effect of competition. To date, competition among companies has not been a significant problem, but as more loans are made the risk of job loss among competing firms will increase. Among existing loans, two cases deserve mentioning. One received a Small Business Development Loan, the second received a Minnesota Fund Loan.

The first example is a Small Business Development loan to a wholesaler and distributor of meats, poultry, cheese, and seafood. The company fills a void left by major packing houses. Major packers have a minimum delivery order of 3,000 pounds, which is prohibitive for smaller independent retailers. Major packers once handled small orders, but in recent years they have set higher minimums because of the overhead. The company receiving the state loan fills this void by supplying these smaller retailers.

Any increase in the capacity of this company will cause more meat, cheese, and seafood products to be sold through smaller retailers, with a possible reduction in sales by major retailers and major packing companies. Thus, expanded employment at this company and smaller stores may be somewhat offset by declining employment at larger stores and meat packers.

The second example is a new tool and die company which is receiving a Minnesota Fund loan. Rather than expanding its operations, an established company chose to spin-off a new company which is also a tool and die operation. Some of the new company's key management previously worked for the original firm, and the original company will retain 30 percent interest in the new company. Excess business will be channeled to the new company.

We wonder whether this loan produced any net jobs. In terms of job creation, the new company is in direct competition with the parent. Creating the new company comes at the expense of expanding the original company, and any new business the company receives will come at the expense of growth at the original company and other Minnesota tool and die operations.

There is an additional concern. The original company is helping to finance the new company by loaning it money at 12 percent interest. In contrast, the state is loaning its money at 7 percent interest. Since the parent owns 30 percent of the new company, it stands to gain considerably from its success. We believe that the state should not provide money at a lower interest rate than the parent company is receiving.

DEED should also effectively address the issue of displacing private investment. We observed some cases where the firms selected for assistance were financially strong, or where it seemed likely that the private sector would finance expansion and job growth. None of these firms were threatening to leave Minnesota. In funding these projects, DEED remained consistent with its standards of financial prudence, but since the projects might have occurred anyway, these loans may not have created any new jobs.

One example is a Small Business Development loan recipient which produces personalized business forms for the micro- and mini-computer industry. The company is efficient, progressive, and financially strong. Its outlook is bright as the micro- and mini-computer markets continue to evolve. The company is not located in a high unemployment area.

A second company receiving a Small Business Development loan conceded that two different banks were willing to finance its project. But the banks were offering short-term renegotiable loans. The company preferred the long-term, fixed interest rates available under the state program.

Finally, we note that two companies which make plastic injection molds and three tool and die companies are receiving assistance under these programs. According to several sources, these are growth industries. Thus, the state may provide loans to these companies without risk of losing jobs in competing firms. However, when markets are growing and there is strong demand for the products of these firms, the private sector can be expected to provide financing. The main result of the state financing is to influence the pattern of growth. The state can channel more of this growth to specific firms and specific geographic areas, creating more jobs in some areas at the expense of growth elsewhere. While this is a legitimate practice, these loans may create few net jobs. At present, DEED counts the additional employment in these firms as if it was a net job gain for the state.

The number of net jobs created or retained is a central concern of DEED and the Legislature. DEED has given presentations to the Governor and the Legislature detailing total jobs created or retained and funds leveraged through DEED loans. We find that:

- Because the effects of competition and displacement of private funds are not being fully considered, the figures presented by DEED overestimate actual jobs created.

For the most part, the job estimates are a summation of job creation totals given by the firms themselves in their loan applications. Given the emphasis on job creation, firms may be optimistic. They also represent estimates made before expansion projects begin, and they do not include an assessment of jobs lost in competing firms.

We were recently informed that DEED is now contacting firms after the renovation or expansion to verify the number of jobs actually created in these firms. DEED should adopt this follow-up as a standard procedure. However, this review does not address the issue of possible job loss at competing firms or displacement of private capital. We acknowledge that the effects of these two factors are difficult to measure with precision, but more intense efforts to consider competition and private funds displacement can lead to better estimates of jobs created and improved selection of projects.

Need For Economic Analysis

We believe that there is a need for a thorough economic analysis of the loans made through these two programs. Currently, the Financial Management Division has primary responsibility for reviewing loan applications. Staff and management of the division have private sector banking and lending experience. In addition, some members of MEEDA have similar experience. As a result, loan applications receive a thorough financial review.

However, DEED is not obtaining adequate information on a loan applicant's competitors and not adequately analyzing the impact of the proposed loan on Minnesota competitors. Currently, some information on competition is provided to the Financial Management Division through questions asked on loan application forms, but the source is biased and incomplete. The applying firm may downplay the extent of competition since high competition suggests high firm risk. Also, the company may recognize that jobs it creates may come at the expense of other Minnesota competitors. This may again lead the company to discount its competition or delete information about competitors. The existing information is used by DEED staff to assess the financial risk of the proposed loan. It is not being used to analyze whether the creation of jobs at one firm will result in job losses at others. As a result, MEEDA does not have the information it needs about the impact that a proposed loan may have on other competing firms in Minnesota.

We recommend that:

- DEED staff should obtain better sources of information on the number and location of competing firms in Minnesota and characteristics of the product markets affected.

- Staff from the department's Policy Analysis Division should be involved in the review of proposed loans and provide input regarding the impact of the loan on competing firms in Minnesota.

Economic analysis by the Policy Analysis Division is also needed to review the extent to which proposed state loans would displace private capital. When public funding is used for a project that would have occurred anyway, there is no net gain in income or employment.

We believe that displacing private capital is most likely to occur when DEED assists financially strong firms with financially sound projects. DEED management claims that assisting strong firms is consistent with net job creation. We believe that this argument needs to be more carefully examined. First, DEED management says that stronger firms are most likely to complete the project and provide long-term new jobs. This is true. However, since the firms are financially strong, the projects would probably occur without state assistance. Second, management says that providing long-term fixed rate financing protects these firms from risk, further guaranteeing that the state is creating long-term employment. If these projects were funded by banks using short-term variable rate loans, the company's existence could be threatened by another period of very high interest rates. While there is truth to this argument, strong firms are at less risk than the majority of small firms. We question whether these programs are best used to protect a small number of strong companies from such risk. We think it would be more productive to target financial incentives to projects that would not have otherwise been undertaken in Minnesota without a public subsidy.

We recommend that:

- DEED and MEEDA should not use its loan programs to assist projects that would have proceeded in Minnesota without a public subsidy.

- DEED should use its Policy Analysis Division staff along with its Financial Management Division staff to analyze whether loan applicants need public subsidies in order for their projects to be undertaken in Minnesota.

Program Design and Use

One use of the Minnesota Fund is to attract and retain firms. While it may be in the state's interest to offer subsidized financing in some of these cases, the inducement should be no more than necessary. MEEDA can set an interest rate based on financial offers the company may have from other states, but setting a rate involves far more than matching the company's best offer. Any advantages or disadvantages Minnesota has in quality of life, productivity, transportation costs, and other factors should be considered. DEED should also consider the value of the company in terms of jobs and tax base to the state and region. The cost to the state, as measured by the amount of subsidy to the firm, should be compared with the cost of other alternatives to provide comparable jobs and tax base. Although many firms may request assistance, it will frequently be true that no assistance should be offered.

The Financial Management Division does make an effort to weigh these various concerns in its internal decisions and its recommendations to MEEDA. In our view, using economic analysts from the Policy Analysis Division to review these cases would improve the process.

The Minnesota Fund is also used to assist Minnesota companies not considering leaving the state. In these cases, we believe that DEED should reconsider the standard practice of charging below-market interest rates on Minnesota Fund loans.

Several such projects have received Minnesota Fund loans at 7 to 8 percent interest (the highest we have observed is 10 percent). The argument generally made by DEED staff is that these companies need access to capital at reasonable rates. It does not follow that those rates need to be well below market rates and also below rates available with industrial revenue bond financing.

In instances in which a Minnesota company is not considering leaving the state, the Minnesota Fund should be used to enable the company to receive private or other financing sufficient for a project to be undertaken, but not to subsidize a project that would have been undertaken without a Minnesota Fund loan or to provide more subsidy than is necessary. Providing assistance to projects that would not have otherwise occurred might involve: 1) providing market-rate financing in participation with other lenders, 2) providing market-rate financing but taking a second position on some collateral, or 3) providing below-market-rate financing.

DEED needs to more carefully review the type of state involvement needed to permit a Minnesota firm to expand. The state's involvement should be limited to the least costly means of creating jobs. This would mean that below-market-rate financing is not always necessary. As a result, we recommend that:

- DEED and MEEDA should reconsider the standard practice of charging below-market interest rates on Minnesota Fund loans.

As noted earlier, Small Business Development loans are funded by tax exempt bonds, and MEEDA uses monies from the Economic Development Fund to guarantee the bonds. This is a good economic development tool. However, we have noticed that in a few instances private lenders were willing to assist or completely finance projects that were completely financed through the Small Business Development Loan Program. Given the availability of private financing, perhaps no public financing should be offered in those instances. Another possibility is to fund some of these projects through the Minnesota Fund with joint public/private financing. We recommend that:

- When private lenders express interest in financing part or all of a project, DEED and MEEDA should consider using the Minnesota Fund or simply letting the private sector finance the project.

b. Special Assistance Program

Although the Special Assistance Program has only been used once since being authorized during the 1984 legislative session, the program provides DEED and MEEDA with some very useful economic development tools. The Special Assistance Program could be used by DEED to help attract or retain larger firms whose potential impact on employment in the state is significant.

However, because of the amount of state assistance that may be used for any single project, we believe that DEED and MEEDA should very carefully consider: 1) how much assistance is necessary for a given project to be undertaken, and 2) what form that assistance should take. We recommend that:

- DEED and MEEDA should use the Special Assistance Program without guarantees whenever possible.

If the full $10 million bonding authority is eventually used to make loans under this program, DEED could tie up $2.5 million from the Economic Development Fund in the form of a 25 percent guarantee account. This would shift risk away from bondholders unto taxpayers and tie up funds which could otherwise be used for other economic development efforts. Unless it is demonstrated to be necessary, a guarantee should not be used. In the Special Assistance Program individual loans will exceed $1 million. With loans of this size, it may be possible to issue loans without a guarantee in some cases.

DEED and MEEDA appear to be already headed in this direction. At a recent MEEDA meeting, the Authority directed DEED to consider whether a guarantee was necessary for a proposed Special Assistance loan under consideration.

Finally, we believe it is important for DEED to involve its Policy Analysis Division in the review of proposed Special Assistance loans. As we pointed out earlier, economic analysts from the Policy Analysis Division should assist MEEDA by reviewing the impact that a proposed loan may have on other competing firms in Minnesota and attempting to better estimate its job creation potential.

B. OTHER LOAN PROGRAMS

1. OPPORTUNITIES MINNESOTA, INCORPORATED (OMNI)

Created by MEEDA in 1983 to use federal Small Business Administration (SBA) funds, OMNI (Opportunities Minnesota, Inc.) is a private corporation certified by SBA. The OMNI program loans federal funds for economic development to businesses that meet federal small business guidelines. The OMNI board, whose members are prominent in the business, banking, and government sectors, recommends loan recipients to the SBA. If a loan project is accepted by the SBA, then the SBA issues and guarantees the debt to finance the loan. Interest rates are set 1/4 to 3/4 of a percentage point above U.S. Treasury bills of similar maturity.

The federal government initially allocated $2.8 million to Minnesota for this program during the fiscal year ending September 30, 1984. Because some states did not use their allocations, Minnesota's allocation was later increased to $4.3 million.

The maximum OMNI loan is $500,000. OMNI's share of the loan cannot exceed 40 percent of project cost. The applicant must contribute at least 10 percent equity. The remaining financing is provided by banks or other public programs.

To be eligible, the company must meet SBA size standards and cannot have net worth exceeding $6 million or net profits exceeding $2 million. The loans cannot be used for working capital or refinancing. The program is open to a wide range of commercial, retail, and manufacturing companies but federal guidelines exclude lending institutions, gambling facilities, non-public recreational facilities, and real estate investment companies.

DEED supplies support staff to the OMNI Board. However, the OMNI Board is free to set its own policies within federal guidelines.

The purpose of the OMNI program is to stimulate economic activity in Minnesota and create jobs. However, as Table 3.3 shows, 39 percent of the loaned funds went to retail and restaurant-lodging businesses while 37 percent went to manufacturing firms.

TABLE 3.3

SMALL BUSINESS LOANS APPROVED BY OMNI

	OMNI*		
	# Loans	$ Loaned	Percentage of $ Loaned
Manufacturing	8	$1,221,000	37%
Food Processing	1	137,000	4%
Service	3	366,000	11%
Training, Recreation Center	1	262,000	8%
Retail	6	772,000	24%
Restaurants-Lodging	1	500,000	15%
TOTAL	20	$3,258,000	100%

Source: Based on information provided by DEED.

*Excludes three loans rejected by SBA and two loans on hold.

Retail businesses and restaurant-lodging establishments tend to compete in local markets and are strongly influenced by local conditions. Sales and profits are depressed when the local economy is depressed. They are less likely to act as a stimulus to a depressed local economy. They also tend to compete against one another, with expansion of one coming at the expense of others.

We believe that the economic development potential of the OMNI program may be reduced by funding of retail and commercial operations. Recently, the OMNI Board discussed the issue of targeting loans. According to DEED staff, the board concluded that if federal funding for the program is significantly reduced, the board would restrict eligibility to manufacturing firms. We recommend that:

- Even if federal funding is not reduced, the OMNI Board should target OMNI loans to the types of businesses most likely to create net jobs for the state. Retail and other types of businesses that would create jobs at the expense of other firms should be given lower priority. They should be funded only if projects of higher job creation potential do not exhaust the federal allocation.

2. MINNESOTA PLAN

In 1982, the SBA authorized MEEDA's predecessor to provide long term, fixed rate financing for small businesses by selling bonds. The program, called the Minnesota Plan, began making loans in January 1984 paid for by bonds guaranteed by the SBA. By March 1984, the Minnesota Plan had issued nearly $4 million in loans at a rate of 12.95 percent.

Under procedures for the program, a bond is first sold. The proceeds from the sale constitute a pool of loan funds. Applications are then accepted from interested companies. Loan recipients receive fixed rate financing based on the rate at which the bonds were initially sold.

Although the first offering of bonds was successful, MEEDA may not continue the program because its success depends on the timing of the bond sale. If interest rates declined sharply soon after the sale, companies would seek funds elsewhere and MEEDA might not be able to make loans from the funds raised. If DEED and MEEDA can develop procedures to avoid or greatly reduce this risk, additional financing may be offered under this program.

3. FARM LOANS

Legislation passed in 1984 established a state program to provide farm loans. No loans have been made, and no rules or procedures exist for the program.

The law requires that:

- Applicants must be selected by banks, and the loans must be serviced by the banks;
- Funds for the program must be raised by issuing industrial revenue bonds;
- Loans are available only to farms that meet the SBA definition of a small business, thus restricting the program to farms with annual gross sales of $100,000 or less; and
- Each farm loan cannot exceed $100,000.

These restrictions make it difficult to develop a program that is both cost effective and addresses any significant farm problem. The requirement of bank involvement and the low principal per loan would result in high administrative costs. Also, the key financial problem facing farmers is high existing debt. However, this program cannot be used to reduce the existing debt burden because industrial revenue bonds cannot be used for refinancing. While the interest rate on this new program could be attractive, taking out new loans would simply add to the existing debt burdening Minnesota farmers.

We conclude:

- In its present form this farm loan program cannot address any significant farm problem. To be effective it must be modified, including perhaps dropping use of IRBs as the funding source.
- Unless the program is redesigned, it should be discontinued.

DEED agrees with these conclusions and has recommended to the Legislature that the program either be modified or deleted from statute.

Several months ago, DEED was considering making a group of loans under this program. A Minnesota company may close a turkey processing plant because it cannot get an adequate supply of turkeys from the surrounding farm area. DEED considered developing rules for the farm loan program and providing loans of $100,000 to 30 farmers (a total of $3 million). The loans might have allowed these turkey farmers to expand their operations, providing an adequate supply for the plant. However, after thoroughly studying this case, DEED concluded that farm loans would not be appropriate. The department is considering providing assistance to the plant through one of its business loan programs.

Grant Programs

Chapter 4

In addition to its loan programs, DEED can finance economic development projects through grants. This chapter examines three grant programs and several special project grants administered by the department. Section A focuses on the federally-funded Small Cities Block Grant program and the state-financed Economic Recovery Fund. Section B reviews the Community Development Corporation grant program. Section C discusses the state grant for the Minnesota Technology Corridor in the city of Minneapolis. Section D analyzes several legislatively-mandated grants approved in 1984.

A. GRANTS TO CITIES

Many Minnesota communities are giving increased priority to creating new employment opportunities or retaining businesses in their communities. The Community Development Division of DEED administers two programs that provide financing for local economic development projects. The Small Cities Block Grant program (SCBG), funded by the federal government, provides grants to non-entitlement cities, counties, and townships, which generally then loan the funds to businesses at low interest rates. The Economic Recovery Grant program (ERG), a state-funded program initiated in 1984, is modeled after the SCBG program, although grants are available to local governments of any size and to Indian reservations.

Other ways in which Minnesota cities receive funding for economic development projects include the Entitlement Community Development Block Grant program, through which seven cities and three counties receive funding directly from the federal government, and the Urban Development Action Grant program, which awards federal funding to local development projects on a nationally competitive basis. The state has no oversight responsibilities for these programs.

In this section, we examine the two community development programs administered by DEED. Specifically, we raise two questions:

- What type of projects are funded through the Small Cities Block Grant and Economic Recovery Grant programs?
- Are the programs implemented in a way that meets state economic development goals?

Part 1 describes each program and the projects funded through them in recent years. Part 2 presents our analyses of the programs and their effectiveness in stimulating economic development.

1. DESCRIPTION

Non-entitlement cities, counties, and townships are eligible for federal grants through the Small Cities Block Grant program. Until 1983, the grants were distributed directly to local governments by the Department of Housing and Urban Development (HUD). The program has since been changed so that the grants are awarded through the states. The Minnesota program, which received $22 million in federal funding in 1984, is administered by DEED's Community Development Division. Program staff estimate that funding levels will remain fairly constant in 1985.

Federal program guidelines list three eligible uses for grant funds: housing, public facilities, and economic development. According to state rules, 15 percent of the available federal funding in FY 1984 (approximately $3.2 million) was reserved for economic development awards. Grants may not exceed $500,000.

To be eligible for a Small Cities Block Grant, the economic development project must meet at least two of the following federal objectives: 1) benefit low and moderate income residents of a community (defined as 80 percent or less of the median area income), 2) eliminate slums and blight, or 3) address urgent community development needs that pose threats to public health and welfare for which no other funding is available. The state is allowed to establish additional criteria for the program. Minnesota requires that all projects meet at least two of the following three criteria: 1) create or retain permanent private sector jobs with the minimum ratio of one job to every $20,000 in grant funds, 2) leverage a minimum of $1 of private funding for each $1 in SCBG funds, or 3) increase the local tax base of the project property by 50 percent or more.

The grant funds may be used for a variety of economic development purposes. Cities may acquire land or make public improvements for a proposed business development site. They may provide assistance to new or existing small businesses or minority businesses through loans, guarantees, or interest supplements. Eligible loan uses include working capital, land or structures acquisition, property improvements, and equipment.

One important feature of the SCBG program provides for the retention of repaid loan funds at the local level, thus creating a revolving fund for use in future economic development projects. These future projects do not need approval from either the federal or state government, but they are supposed to be related to economic development.

In FY 1984, the entire federal allocation was awarded in the first six months of the program. Grants were awarded to 14 cities and one county, as shown on Table 4.1. Of these awards:

- Eleven are manufacturing projects, three of which are for food product manufacturing;
- One prepares a city's infrastructure for two planned development sites;
- One is for construction of an ice arena and renovation of a nursing home into a residence for training figure skaters; and
- One is for a retail business.

To supplement the Small Cities Block Grant program, the 1984 Legislature appropriated $6 million for an Economic Recovery Grant program during FY 1985. The entire state allocation is for local economic development projects. The Economic Recovery Grant program differs from the SCBG program in two important ways. First, ERGs are available to any Minnesota city, county, or township regardless of size and to Indian reservations. The SCBG program, on the other hand, limits eligibility to non-entitlement cities, counties, and townships. Second, whereas the SCBG program allows the entire grant allocation to remain at the local level, the Economic Recovery Grant program requires cities to pay back the grant proceeds exceeding $100,000. In addition, the city retains the interest earned on this amount of loan principal. DEED receives the remaining principal balance and the interest earned on that amount. The commissioner of DEED may use these funds for future economic recovery grants.

Through February 1985, DEED awarded Economic Recovery Grants to 25 Minnesota cities for economic development projects. Table 4.2 lists these awards. The combined total of these grants amounts to approximately $4.5 million. Of the 25 awards, 21 were for manufacturing projects, two were for agricultural projects, one was for a retail project, and another was for a combined tourism and alternative energy project. Some of the businesses stated that without the grant they might have relocated their operations to neighboring states.

TABLE 4.1

SMALL CITIES ECONOMIC DEVELOPMENT BLOCK GRANTS[1]

Recipient	Project	Award	Terms of Loan	Job Claims
Albert Lea	Assist CornBelt Meats in purchasing an existing meat packing facility.	$500,000	1% over 1 year	1,800 retained
Aurora	Assist the construction of a drugstore complex.	$130,000	8% over 15 years	10 created
Blackduck	Assist expansion of Anderson Fabrics, Inc.	$249,970	6% over 15 years	57 created
Chandler	Assist expansion of Huisken Meat Center, Inc.	$ 72,000	0% over 12.5 years	71 retained 15 created
Deerwood	Assist in machinery and equipment purchases for Cedarbrook Ice Arena.	$200,000	6.84% over 15 years	30 created
Elbow Lake	Assist expansion of Cosmos International, an automotive parts manufacturer.	$150,000	7% over 5 years	25 created
Granite Falls	Assist Fluid Technology, Inc. in acquisition of a pump and hydraulic cylinder manufacturing facility.	$250,000	10% over 10 years	123 created
Lake County[2]	Acquire land for Louisiana Pacific waferboard siding plant.	$500,000	Not a loan[3]	100 created

Recipient	Project	Award	Terms of Loan	Job Claims
Milaca	Assist in construction of a Medtronics assembly plant.	$ 85,000	1% over 20 years	40 created potential for 185 more
New Ulm	Assist city in acquisition of industrial building for Industrial Air of Minnesota, Inc., an air compressor manufacturer.	$230,000	10% over 10 years	64
Onamia	Assist in reopening of garment manufacturing plant.	$225,000	7% over 5 years	45 rehired
Pipestone	Assist expansion of Town and Country Meats.	$200,000	years 1-3 at 3%, years 4-10 at 7%	40 created
Princeton	Public works improvements in an industrial park.	$202,000	not a loan[3]	318 created
Staples	Assist expansion of McCourtney Enterprises, Inc.	$252,000	6% over 10 years	32

Source: DEED.

[1]Includes all Small Cities Economic Development Grants awarded since December 1983.

[2]According to the agreement between DEED and Lake County, $100,000 of this grant will be returned to the state for use in future SCBGs.

[3]These two projects consisted of land acquisitions and infrastructure improvements rather than loans to private businesses.

TABLE 4.2

ECONOMIC RECOVERY GRANTS*

Recipient	Project	Award	Terms of Loan	Job Claims
Alexandria	Assist start-up of Donnelly Custom Manufacturing, manufacturer of molder plastic parts.	$250,000	6% over 7 years	27 created
Becker County	Assist expansion of the Village of Smokey Hills, a retail facility selling handicraft items to tourists.	$106,000	6% over 10 years	21 created
Blue Earth	Assist acquisition of a building for Telex Communications, which assembles projection equipment.	$125,000	9% over 10 years	100 created
Braham	Provide working capital to Dahlman, NFD, Inc., a manufacturer of root crop equipment and machinery.	$214,000	3% over 5 years	42 created
Clarkfield	Provide working capital for Clarkfield Enterprises, a manufacturer of outdoor clothing.	$ 52,500	8% over 10 years	14 created
Cook County	Assist expansion of Hedstron Lumber Company's sawmill operations.	$250,000	8% over 15 years	13 created

Recipient	Project	Award	Terms of Loan	Job Claims
Dalton	Assist reconstruction of city's grain elevator.	$ 75,000	5% over 5 years	4 retained 4 created
Duluth	Assist expansion and relocation of Erwin Weller Co., a Sioux City, Iowa fishing tackle manufacturer.	$250,000	6% over 10 years	30 created potential for 20 more
Dunnell	Assist reconstruction and expansion of Glassite, Inc., a truck-topper manufacturer.	$230,000	6% over 10 years	35 created potential for 75 more
East Grand Forks	Assist relocation of Ideal Aerosmith, Inc. from Wyoming. Company manufactures aircraft and marine test equipment.	$250,000	1% over 15 years	21 created potential for 41 more
Edgerton	Assist expansion of Fey Industries' vinyl products manufacturing operation.	$128,137	3% over 10 years	30 created
Ely	Assist development of Pioneer Lodge and Convention Center ($200,000) and Zenith Properties, a district heating system and greenhouse ($25,000).	$225,000	$200,000 at 10% over 10 years; $25,000 at 10% over 7 years	35 created
Faribault	Assist relocation of Faribault Canning Co.'s Colorado plant and expand to year-round operation.	$247,550	7% over 15 years	17 created
Hallock	Assist expansion of Lake States Systems, Inc., to manufacture wind energy systems.	$128,350	4% over 10 years	9 created

Recipient	Project	Award	Terms of Loan	Job Claims
Hibbing	Provide working capital to Abe Mathews Engineering Company, which manufactures electrical power doors.	$255,000	1% over 5 years	30 created
LeSueur	Assist relocation of Telex Communications, Inc. from New York. Company produces slide projectors.	$125,000	6% over 10 years	78 created
Maple Plain	Provide public facilities needed to retain and facilitate the expansion of two local businesses.	$222,510	none	20 retained 21 created
Red Wing	Assist equipment purchase for S.B. Foot Tanning Company.	$100,000	8% over 6 years	314 retained
St. Charles	Assist expansion of North Star Foods, Inc., a poultry processing facility.	$250,000	6.25% over 15 years	50 created
St. James	Provide working capital to Tony Downs Foods, Inc.	$205,000	5% over 5 years	429 retained
St. Paul	Assist Ideal Security Hardware Corp. to acquire and relocate a manufacturer of screen hardware and Christmas tree stands.	$250,000	6% over 5 years	33 created
St. Peter	Assist expansion of GTO Electronics, which manufactures power converters, inventers, and battery isolators.	$125,000	5% over 20 years	30 created

Recipient	Project	Award	Terms of Loan	Job Claims
Stacy	Assist expansion of Subtronics, Inc.'s small power transformer operation.	$100,000	3% over 20 years	62 created
Wadena	Provide working capital to Country Fair Foods, Inc., a producer of pickles. Grant will leverage a public works grant from the federal government.	$212,500	$150,000 at 8.75% over 7 years; $60,000 at 8.75% over 15 years. Remainder is used for grant administration	13 created/ retained
Winnebago	Assist expansion of Minnesota Electric Technology, Inc., a producer of small DC motors.	$ 60,000	2.5% over 5 years, 5% for remaining 10 years	20 created

Source: DEED.

*Includes all grants awarded as of February 1985.

The Department requested an additional $4 million for the Economic Recovery Grant program in each year of the 1986-1987 biennium, bringing the annual program budget to $10 million. The Governor recommended no increase in the program's budget.

2. ANALYSIS

Our review of the Small Cities Block Grant and Economic Recovery Fund programs revealed that:

- The vast majority of funds have been targeted to manufacturing firms. However, one grant was made for reconstruction of a drug store through the Small Cities Block Grant program. Program staff indicate that this project was approved because it would benefit the community. Similarly, one retail project was funded by an Economic Recovery Grant.

- The number of jobs claimed to be created or retained varies widely among the funded projects. For example, among the 1984 SCBG projects, the numbers of jobs ranged from 6.7 jobs created in Aurora (awarded $130,000) to 1,800 jobs retained in Albert Lea (awarded $500,000). For Economic Recovery grants, the numbers ranged from 8 jobs created in Dalton (awarded $75,000) to 429 jobs retained in St. James (awarded $205,000). All projects, however, meet the $20,000 per job limit set by state review criteria.

The Small Cities Block Grant and Economic Recovery Fund have generally been targeted to manufacturing businesses, which are more likely to have a net impact on the economy than retail businesses. However, like other economic development programs, this alone does not guarantee that the program will be successful in generating net economic growth for the state. DEED does require applicants to document need for the the grant. However, based on the information supplied by applicants, it is difficult for program staff to conclusively determine what level of subsidy--if any--is needed for a project to proceed. In addition, the grant review process does not adequately consider the effects the project will have on competing businesses in Minnesota. To ensure that the state's economic development goals are met through these programs, program staff should give greater consideration to these issues in the grant review process. Staff from the Policy Analysis Division and the Financial Management Division should assist program staff in addressing these issues.

In addition, we wonder whether it is in the best interests of the state to allow up to $100,000 plus interest from state Economic Recovery Grants to remain at the local level, an issue debated by the 1984 Legislature. DEED staff believe that this arrangement is preferable to requiring total repayment of the grant funds because it allows local governments to develop economic development capacity. However, we find several reasons why it may be beneficial to require that the entire grant be repaid to the state. First, allowing the cities to retain a portion of the funds lessens the amount of oversight the state can have in future expenditures. While the initial projects funded through this program may provide benefits to the state economy, subsequent city projects may be retail or other projects that will not generate net growth in the state economy. If all the funds reverted back to the state, DEED could better ensure that state economic development goals are met through the program.

Second, most of the Economic Recovery awards are relatively small in size. Four of the awards were $100,000 or less, thus the state will not recoup any of these funds. The other 21 awards were for $255,000 or less. Of the $4.5 million awarded to date, the state will recover at most about $2.1 million in grant funds (plus interest) for use in future projects.

Third, many of the cities awarded grants are small in size. These cities may only infrequently have the opportunity to develop manufacturing projects. State goals may be better met if cities applied for funds on a competitive basis than allow a portion of the funds to remain on the local level.

Recommendations

- The Legislature should change the Economic Recovery Grant program so that the entire grant is repaid to the state.

- DEED staff should revise their grant review process to include consideration of the effects the project will have on competing Minnesota businesses and to give additional consideration to how much subsidy, if any, is needed for the project to proceed. Grants should not be awarded for retail and service firms that are dependent on the local economy.

B. COMMUNITY DEVELOPMENT CORPORATION GRANT PROGRAM

In recent years community-based economic development efforts have increased. Some areas of the state have formed community development corporations (CDCs) to influence business development. CDCs operate on behalf of a specific geographic area which may range in size from a neighborhood to an entire region of the state. The type of activity initiated by CDCs varies: some become active partners in business development by operating business loan programs or becoming part-owners and managers of local businesses; others take a less active role, providing assistance and referrals to businesses.

The Legislature established a grants program for community development corporations in 1977. Eight to ten CDCs received funding through this program between 1977 and 1981. From 1982 to 1984, six applicants received funding. The program was appropriated $180,000 for each year of the 1984-1985 biennium and received an additional $500,000 through the 1984 supplemental appropriations bill, bringing the 1985 funding total to $680,000. In FY 1985, the program was transferred from DEED's Financial Management Division to the Economic Development Division.

In assessing the economic development potential of the community development corporation grant program, we asked several questions.

- Does the Department of Energy and Economic Development administer the program in a way that furthers state goals?

- Does the state have goals other than economic development for the community development corporation grant program?

- Is the program likely to be effective in stimulating economic development?

To answer these questions, we reviewed the grant application and review process and the CDC funding requests for FY 1984 and 1985. Part 1 of this section describes the CDC grant program and provides background information on how the program has been implemented. Part 2 presents our findings and conclusions about the program.

1. DESCRIPTION

To be eligible for a community development corporation grant, the CDC must be a non-profit organization operating within a specified geographic community. The boundaries of metropolitan CDCs may conform to either city, township, or neighborhood boundaries while the boundaries of outstate CDCs may not cross existing economic development boundaries, such as those of regional development commissions. Ten percent of the population in the area served by either type of CDC must be below the poverty level. The organization's board of directors may range in size from 15 to 30 members, but at least 40 percent of the board's members must be low income residents of the area in which the CDC operates. Finally, low income residents should be hired in the CDC's non-managerial positions.

Two types of grants are available through this program: planning and venture capital. Planning grants can be used for administrative costs such as personnel, training, and the costs of developing business and venture capital projects. Venture capital grants can be used for loans or direct investments in business start-ups or expansions. The state does not require the CDC to repay any portion of the grants, so repaid loans can be used in future projects. In past years, DEED divided program funds equally between planning and venture capital grants, although DEED expects to award a greater proportion of planning grants in FY 1985.

Review of the grant proposals is a two phase process. DEED staff perform an initial appraisal of each application followed by an evaluation by an application review committee comprised of members from the banking, finance, and business communities. The review committee makes its final recommendations to the commissioner of DEED. The commissioner transmits his recommendations along with those of the review committee and DEED staff to the Minnesota Energy and Economic Development Authority (MEEDA) board. No community development corporation grant may be made without approval of the MEEDA board.

As shown in Table 4.3, eleven planning grants totaling $390,000 were awarded in October 1984. In some cases, the awards were less than that requested, since the review committee felt the organization could find supplemental funding elsewhere. Two proposals for planning grants were rejected: one because it was closely tied to a profit making organization; the other because the CDC did not appear to be able to meet community needs.

DEED is currently accepting requests for venture capital grants. These applications will be reviewed on a first-come, first-served basis through June 30. No venture capital awards had been made at the time of this report although three projects have been reviewed. Statutory criteria for reviewing venture capital proposals include job creation potential, profit maximization, and the amount of non-state funds leveraged by the grant.

DEED staff indicate that in the future, the program will attempt to increase the number of CDCs receiving awards and achieve a wider distribution of grant funds across the state. In addition, while innovative local projects will be encouraged through venture capital awards, staff will direct CDCs to seek other sources of funding for their projects.

DEED's budget request for the 1985-1987 biennium did not include an increase in the Community Development Corporation Grant program. The department did, however, request $90,000 to provide technical assistance to CDCs and other local development agencies and one additional staff member to administer both the CDC grant program and the enterprise zone program. The Governor

TABLE 4.3

FY 1985 COMMUNITY DEVELOPMENT CORPORATION PLANNING GRANT AWARDS

Organization	Location	Planning Grant Request	Planning Grant Award
Arrowhead Community Economic Assistance Corporation	Lake, Cook, and St. Louis Counties (excluding Duluth)	$37,375	$ 30,000
Community Enterprises CDC	Duluth	83,767	50,000
Eastside CDC	St. Paul	27,000	20,000
Fairview CDC	Minneapolis	50,260	25,000
Growth Unlimited CDC	Anoka County	30,000	30,000
Phillips CDC	Minneapolis	36,845	35,000
Region 2 CDC	North Central Minnesota	73,310	50,000
Savanna-Nemadji CDC	Aitkin and Carlton Counties	48,500	20,000
Westbank CDC	Minneapolis	75,000	40,000
Western 5 CDC	6W Economic Development Region	50,681	40,000
Whittier Alliance	Minneapolis	77,000	50,000
Total			$390,000

recommended that the CDC grant program be discontinued. In the Governor's view, local governments should be responible for supporting the efforts of CDCs.

2. ANALYSIS

Our review of the community development corporation grant program reveals that:

- Four organizations have been the primary receivers of the grants.

- In the past, DEED has not encouraged CDCs to become financially self-sufficient by requiring them to seek other sources of planning funds. Rather, DEED's policy has encouraged CDCs to seek state planning grants annually.

- Few venture capital projects have been approved during the 1984-1985 biennium making it difficult to assess the effectiveness of this part of the CDC grant program.

Table 4.4 shows the awards made through the community development corporation program from 1982 to 1984. Four CDCs received over $500,000 or 95 percent of the total funds available in those years. Using state funds to benefit only four organizations may not be consistent with the legislative intent to assist community-based economic development efforts. However, recent efforts by DEED to increase the number of participating CDCs will improve these distributional problems.

Planning awards can help CDCs initiate economic development activities, since funds can be used for staffing, training, and other administrative costs. Although necessary for the economic development effort, planning does not guarantee that jobs and economic growth will occur. CDCs must be able to effectively implement their plans in the form of economic development programs and projects. Our examination of the CDC applications reveals that DEED does evaluate planning proposals on the basis of past performance by the CDC and reward those that are active in implementing projects. In our opinion, this is a good criterion for review.

Nonetheless, we do question whether it is appropriate policy to consistently fund administrative costs for a CDC over a number of years. The four CDCs receiving administrative funding for each year in 1982-1984 also received planning grants in FY 1985. These CDCs, being active and established, could find other sources of funding for these costs. Reducing their reliance on state grants for administrative costs would free funds to assist newly established CDCs. We believe that:

TABLE 4.4

COMMUNITY DEVELOPMENT CORPORATION PLANNING AND VENTURE CAPITAL GRANT AWARDS

FY 1982 - FY 1984

	FY 82		FY 83		FY 84	
Organization	Planning	Venture Capital	Planning	Venture Capital	Planning	Venture Capital
Community Enterprises (Duluth)	$10,000		$30,000		$ 41,000	
Koochiching-Itaska CDC	18,000					
Region II CDC	35,000	$ 50,000	30,000	$51,360	30,000	$41,000
Savanna-Nemaji (McGregor, Minnesota)	8,000		9,170		15,000	
SEMAC (Southeast Minnesota)			5,000			
West Bank CDC (Minneapolis)	5,034	27,000	20,000	42,810	20,000	35,000
Total	$76,034	$77,000	$94,170	$94,170	$106,000	$76,000

- DEED should evaluate the purpose of planning grants and consider their use solely for new CDCs offering potential for successful development rather than providing a annual source of administrative funds.

Indeed, the Department may already be moving in this direction: each of the four CDCs received smaller planning awards than was requested since the review committee believed they had access to other funding sources.

Only two CDCs received venture capital grants in 1984, limiting our ability to determine the effectiveness of this program. One was for a restaurant/entertainment facility. DEED staff defend this project because it will provide jobs for low income residents. However, such a project is not in keeping with the philosophy that state programs should not subsidize businesses that serve the local economy at the expense of similar businesses in the area.

DEED awarded the other 1984 venture capital grant for use in the expansion of a ceramics firm. From an economic development perspective, this project is more desirable than the first example. The ceramics firm exports its products to other states, thus bringing money into Minnesota. The expansion project may allow the company to reduce its costs because it will consolidate production processes. Nevertheless, one must question whether a subsidy was needed to bring about this development. The grant application indicates that the expansion was necessary to meet the demand for the company's products. It may be that the project could have proceeded without the subsidy.

Finally, we question whether CDCs should be allowed to retain the venture capital funds rather than returning these funds to the state. Similar to the Small Cities Block Grant and the Economic Recovery Fund programs, this practice lessens the amount of state oversight on future expenditures of the funds. If the funds reverted back to the state in a revolving fund, DEED could ensure that subsequent CDC projects meet state economic development goals.

Recommendations

Based on our review, we believe that:

- The Community Development Corporation Grant program should be reevaluated. Specifically, the need for planning grants and venture capital grants should be reconsidered.

A different policy on planning grants would improve the effectiveness of the program. Rather than providing an annual source of funding for a few CDCs' administrative costs, we believe the grants should be used to assist new and growing CDCs. This would require CDCs to become self-sufficient. In our opinion, this change would make better use of state funds, and it would increase the number of organizations initiating economic development activities.

We believe the Legislature should consider whether CDC involvement in economic development projects provides enough benefit to justify the costs of the program. Many local business projects can receive funding through DEED's loan programs. Competitive statewide loan programs allows DEED to rank the benefits of a project against those of other projects. In addition, the state funds are eventually recouped and retained at the state level. This approach may better achieve state economic development goals than the CDC venture grant program.

Certainly, the economic and social benefits of CDC involvement in business projects should be documented before any additional funds are appropriated for venture capital grants. Without this information, it is impossible to determine whether the venture capital program should be continued. If the program is continued, we believe the Legislature should consider requiring repayment of the grant funds. In this way, the state could reuse these funds in future projects.

C. TECHNOLOGY CORRIDOR

1. DESCRIPTION

The "Technology Corridor" project was initiated by the city of Minneapolis in February 1983 with a Task Force on Research and Technology. This task force was charged with developing a strategy to increase the percentage of high technology firms in Minneapolis. The task force recommended the development of a technology corridor, a specific geographic area where high technology firms would locate to be near the University of Minnesota's resources, a quality labor force, and other high technology firms. Examples of similar areas in the United States include the regions surrounding the Massachusetts Institute of Technology and Stanford University and the Research Triangle, an area bounded by three universities and the state capital in North Carolina. The Minneapolis site is contained within both a tax incrementing financing district and a Minnesota enterprise zone.

According to project developers, a major attraction drawing high technology firms to the corridor will be the Technology Corridor Service Center housing the Minnesota Computer Center (the "supercomputer institute") and an "outreach" office of the university. Businesses will be able to use the computer services available through the University and may be able to participate in classes given on campus through a telecommunication system. The outreach office will facilitate business access to university resources and will assist in creating new businesses through transfer of technology developed in the corridor.

The development plan for the corridor prepared by the Minneapolis Community Development Agency and the city Planning Department states that primarily research and development firms will be encouraged to locate in the corridor. This choice is based on locational needs of businesses: these firms will benefit from proximity to the University's resources. Manufacturing firms require substantial amounts of space that will not be available within the corridor.

The 1984 Legislature appropriated $6 million dollars to assist in the development of a technology corridor. As specified in the 1984 supplemental appropriations bill, these funds could be used for "land acquisition costs, building construction costs, and venture capital assistance within the technology corridor."[1] The commissioner of DEED was to negotiate with the city of Minneapolis and the University of Minnesota and specify how the state funds would be spent. The expenditures made with state funds were to be the "most appropriate reasonably available means of promoting the development of technology-related businesses in Minnesota."

In January 1985, the commissioner of DEED, Minneapolis officials, and University representatives entered into an agreement for constructing an $11 million service center facility in the technology corridor. The University will occupy 80,000 of the facility's total 105,000 gross square feet. The remaining 25,000 square feet will be available for lease to tenants. Funding for the project will come from:

- $5 million in state funds,
- $4.5 million from the city of Minneapolis, and
- $1.6 million from the University.

The additional $1 million of state funds available for the technology corridor was committed in the approporiations bill to the University for recurring costs associated with the new supercomputer institute. The University's contribution to the service center is based on an estimated $2 million dollars from the sale of its current supercomputer minus the estimated $400,000 in relocation costs.

2. ANALYSIS

DEED did not have to appropriate the entire state allocation to the development of a supercomputer institute. The 1984 supplemental appropriations bill requires that only $1.2 million of the state funds needs to be used for this facility. Other uses for state funds could have included land purchase and venture capital for high technology businesses. DEED staff cite two reasons for the decision to devote all state funds to the service center. First, actual costs for the center will exceed original estimates. Neither the city nor the University were in the position to contribute more than that called for by the final agreement. Second, the commissioner and DEED staff believe that the service facility is crucial to the success of the corridor. Thus, they believed it appropriate to use the state funds to guarantee that the center is built.

The ideas of a sophisticated computer center and strengthening University ties with the business community may be effective ways to encourage economic development. A strong university is often cited as a reason why businesses, particularly high technology businesses, choose to locate in a given area. Thus, the technology service center may be an effective magnet for economic development.

We are concerned, however, about the likelihood of Minneapolis officials requesting additional state funds for the technology corridor. When evaluating such requests, we believe the Legislature should consider whether the additional costs will provide net benefits to the state. If the computer service center is a major attraction for businesses, additional assistance may be unnecessary to attract them to the corridor. In addition, it is likely that the city of Minneapolis will be providing many of the businesses locating in the corridor with incentives through the state enterprise zone program, tax increment financing, or industrial revenue bonds. If additional incentives are needed, they should be funded through existing state programs, rather than providing additional direct assistance to the technology corridor.

A final point that deserves consideration is that high technology firms do not need to be located within the technology corridor to use many of the services provided by the University and the computer facility. Access to some of these services can be gained through computer modems, similar to how businesses use the current services available from the University campus. Accordingly, the attraction of the computer service facility will go beyond the immediately adjacent area and high technology development may be stimulated throughout the metropolitan area. Providing additional subsidies to the technology corridor may cause simply a shifting of development from other metropolitan locations to Minneapolis. While this may benefit the city of Minneapolis, it will not necessarily provide net benefits to the state.

Recommendations:

- The Legislature should continue to explore ways to attract economic development through a strong University program. Any additional support to the technology corridor should be provided through existing state economic development programs rather than direct appropriation. In this way, the economic benefits of the corridor development can be weighed against competing projects throughout the state.

D. LEGISLATIVELY-MANDATED GRANTS

In 1984, the Legislature appropriated $3.5 million to the commissioner of DEED for grants to three specialized projects.

- Up to $1 million may be granted to a meat processing and packing company that is renovating or expanding facilities. The company must provide over 20 percent of the industrial employment in its city.

- Up to $2.4 million may be granted to a manufacturer of internal combustion engines, generators, electrical generating sets, and switch gear that is renovating or expanding its facilities. The company must provide over 10 percent of the industrial employment in its city.

- Up to $100,000 may be granted to a city selected as a site for a foreign company that assists other foreign firms in manufacturing products in the United States. The city may use the funds in any way it deems appropriate to assist the company.

The legislation gives DEED the responsibility for selecting grant recipients and monitoring the grants. Cornbelt Meats of Albert Lea received the $1 million grant. The funds may be used to offset property tax increases due to expansion or renovation and part of the sales tax on capital equipment purchases. The grant will be paid out in a single, up-front payment, but the company must submit a five-year plan noting expansion and renovation plans. If the project is not completed according to schedule or if the facility closes, the company will repay a portion of the grant.

Onan Corporation of Fridley was selected for the $2.4 million grant. The grant is restricted to the same uses and repayment provisions as the Cornbelt Meats grant. However, the legislation requires that the qualifying expenditures be made before the grant funds are released.

At this writing, DEED is accepting applications for the foreign manufacturing grant. Unlike the Cornbelt Meats and Onan grants, uses of this grant may take any form, making this grant less restricted. However, the grant will be subject to the same recapture provisions.

1. ANALYSIS

In reviewing these legislatively-mandated grants, we studied the legislation, interviewed DEED staff, and reviewed the grant applications and contracts. We found:

- The recapture provisions established in law are not adequate to protect the state's interest.
- Administrative problems increase when assistance is provided through specialized grants rather than established departmental programs.
- The state is not assured that net economic growth will occur as a result of the grant expenditures.

Due to the up-front release of the Cornbelt Meat grant, the funds are only loosely tied to renovation or expansion expenditures. The grant contract stipulates, however, that increased property taxes resulting from renovation must equal or exceed the amount of the grant. If this is not the case, the company may be required to repay a portion of the grant.

In our opinion, this arrangement is questionable. Under the law's provisions for grant repayment, the company can reduce the amount to be repaid by delaying announcement of project changes. In addition, the law does not address the issue of interest accumulating on the grant funds. The company could keep a considerable amount of interest even if it abandoned the project and returned the grant principal. Finally, we question whether a grant was appropriate in this case at all. Full release of the grant before the project is undertaken allows the company to use the funds for any company need. A loan could serve the same purpose while allowing the state to recoup its investment.

The problems with this grant are compounded by the law's stipulation that DEED not develop rules for grant administration. As a result, many policy issues must be resolved through negotiation, hampering DEED's ability to monitor the grants. For example, while the law requires partial repayment of the grant if the company departs significantly from its project schedule, the law does not provide guidance regarding the content of the schedule or the required level of detail. Disagreements between the parties are possible as to what consitutes an acceptable schedule and what represents a significant departure from that schedule. Without rules, DEED cannot set standards to protect the state's interest.

The Onan Corporation grant funds, on the other hand, will be distributed only after qualifying expenditures have been made. This improves upon the problems of the Cornbelt grant, as the grant is linked directly to the company's expansion. However, security of the state funds is not the only consideration in evaluating this grant. Similar to other economic development projects, the need for public subsidies should be taken into account. If Onan would have expanded their Minnesota facilities without the state grant, the net economic impact of the grant is minimal. Due to the law's specialized criteria for determining grant recipients, DEED could not compare the economic effects of these projects against other projects to determine where state funds would be put to best use.

Some of these problems would not occur if such projects are funded through a state economic development program. The administrative problems caused by the specialized grants would be eliminated because DEED would have rules for the program. Most importantly, assisting these projects through established programs would allow DEED to compare their merits against those of other proposed development projects. Such evaluation is crucial to the success of state economic development efforts.

We recommend that:

- Legislatively-mandated grants should be avoided in the future. Instead, financial assistance to companies should be provided through established economic development programs.

NOTES

[1]1984 Laws of Minnesota, Ch. 654, Art. 2, Sec. 15(k).

Tax Credits

Chapter 5

Similar to the way governments use general tax reductions to stimulate economic growth, tax credits can be targeted to selected businesses in an attempt to stimulate economic growth. By allowing credits on certain types of investments, governments hope to spur development.

The 1983 Minnesota Legislature approved of two economic development programs based on tax credits. The enterprise zone program offers credits to businesses locating or expanding in designated distressed areas. Small business investment credits offer credits to persons or corporations investing in certain types of small businesses or small business assistance offices. This chapter examines these programs and raises questions about their effectiveness in stimulating economic development.

A. ENTERPRISE ZONES

1. PROGRAM DESCRIPTION

Enterprise zones are rapidly gaining attention as economic development tools, and the federal government and many state governments are considering implementing such programs. Enterprise zones are geographically-defined areas in which tax incentives are available to encourage development. They are unique among economic development programs in that the basic eligibility criterion for the incentives is the location of the business rather than the nature of its operations, its size, or its financial status.

In 1983, the Minnesota Legislature appropriated $32 million in foregone tax revenues over an eight year period for a state-funded enterprise zone program. The 1984 Legislature appropriated an additional $3.6 million for the program. The law provides for the establishment of three types of zones:

border cities, competitive city zones, and federally designated zones. Each is described below.

- *Border Cities*: Border cities are intended to promote economic development by reducing the difference between the costs of doing business in Minnesota and neighboring states. (This problem is known as fiscal disparities.) The main goal of this program is equalization--tax reductions to keep existing businesses--rather than creation of new development. The entire city is a part of the enterprise zone, as property tax and job credits may be distributed to existing businesses. Additional credits are available for new or expanding businesses. Moorhead, Breckenridge, East Grand Forks, Dilworth, Ortonville, and Duluth have been designated as border cities. Legislation passed in 1984 stipulates that no more border cities may be designated.

- *Competitive Cities*: The main goal of the competitive zone program is to encourage *new* economic growth in distressed areas. Unlike the border city program, competitive cities may only distribute the tax credits to new or expanding businesses within a designated 400 acre enterprise zone. Two groups of competitive cities have been designated, including Minneapolis, St. Paul, Thief River Falls, Mountain Iron/Virginia, and Mankato in 1983 and Little Falls, Crookston, Montevideo, Hibbing/Quad Cities (Aurora, Babbitt, Hoyt Lakes, and Silver Bay), and the West Range Cities (Grand Rapids, Bovey, Deer River, and Bass Brook Township) in 1984. DEED selected these cities on the basis of the level of distress documented in the zones and the quality of the city's development plan. Unless the 1985 Legislature extends this program, no more competitive cities will be designated.

- *Federal Zones*: No federal zones exist at this time since the federal program has yet to become law. The state program readies Minnesota to apply for designation should Congress enact this legislation.

Table 5.1 shows the state allocations of enterprise zone credits to each designated zone.

Crucial to an enterprise zone's success in retaining or creating economic development is the nature of the incentives available through the program. Minnesota's law allows for four types of state tax credits:

- a state-paid property tax credit for a portion of a new eligible business or the additional property taxes incurred by the expansion of an existing business in the zone;

TABLE 5.1

ENTERPRISE ZONE ALLOCATIONS

Border Cities	
Designated in 1983	
Duluth	$ 6,600,000
Moorhead	6,304,882
East Grand Forks	1,794,279
Breckenridge	821,581
Dilworth	543,307
Ortonville	535,951
Total: Border Cities	$16,537,000
Competitive Cities	
Designated in 1983	
Minneapolis	$ 4,500,000
St. Paul	4,500,000
Mankato	2,500,000
Thief River Falls	1,750,000
Virginia/Mountain Iron	1,750,000
Designated in 1984	
Hibbing/Quad Cities	800,000
West Range Cities	800,000
Little Falls	800,000
Crookston	800,000
Montevideo	800,000
Total: Competitive Cities	$19,000,000

Source: DEED.

- an income tax credit for a portion of the cost of debt financing used to construct new facilities;
- an income tax credit for an employer of up to $3,000 annually for each additional worker employed in the zone (excluding construction workers); and
- exemption from the general sales tax for purchasing construction materials or equipment for use in the zone.[1]

The 1984 Legislature amended the enterprise zone law to make the state income tax credits refundable. This makes the program more attractive to start-up companies, which typically do not have income tax liabilities.

Border city zones are eligible for two additional types of state tax credits:

- a credit against an employer's income tax up to $1,500 per year for existing employees and

- a state-paid property tax credit for a portion of the property tax on an existing commercial or industrial facility.

In addition to the state tax credits, each designated city must provide a local contribution to each business receiving state credits. These contributions usually consist of local property tax reductions. Eligible businesses must apply annually for the tax reductions, which may be taken for five years. Zone designation lasts for seven years.

Designated cities may award enterprise zone credits to businesses meeting the federal codes governing industrial revenue bonds. Under these guidelines, ineligible businesses include:

- retail food and beverage services, automobile sales and service centers, recreation or entertainment facilities, private and commercial golf courses, country clubs, massage parlors, tennis club or racquet sports facilites, skating, hot tubs or suntan facilities, and racetracks.

The 1984 Legislature amended the eligibility provision to allow border cities to distribute credits to retail food and beverage services, automobile sales and service centers, and recreation or entertainment facilities. The commissioner of the Department of Revenue must determine that businesses meet these statutory criteria before the credits may be taken. Enterprise zone cities may, however, place additional restrictions on eligibility to better target the credits to particular types of businesses.

2. PROGRAM ANALYSIS

To evaluate the effectiveness of the enterprise zone program in stimulating economic development, we asked several questions:

- Are the incentives available through the program being effectively targeted to businesses that will generate net economic growth for the state?

- Are DEED and the designated cities implementing the program in a way that furthers state economic development goals?

- What can the state expect from this program in terms of economic development?

Our analysis of the enterprise zone program is presented in two parts. First, we present our analysis of the border city and competitive city programs. We then assess the Economic Opportunity Zone proposal submitted by DEED to the 1985 Legislature.

a. Competitive Cities

To determine the amount and type of development occurring within this type of zone, we contacted representatives of each competitive city designated in 1983 and reviewed the applications of those selected in 1984. Since designated cities are still establishing their local programs, the scope of our evaluation was limited. Nevertheless, we found that:

- Designated cities have not always targeted the enterprise zone tax credits to businesses that are likely to generate growth in the state economy.

- Local officals do not believe that enterprise zone credits alone will bring about significant economic growth in the zones. As a result, other types of economic development tools will be used in conjunction with the tax credits to attract development.

- Some of the development occurring within the zone would probably have taken place without the tax incentives.

These findings lead us to conclude that:

- As currently implemented, the competitive city program will have limited success in creating net economic growth in Minnesota. Instead, the program is more likely to encourage developers to choose enterprise zone sites at the expense of other Minnesota locations including nearby sites in the same general area.

To some, shifting the location of new development to distressed areas is an appropriate goal for the program. However, if the goal is the net creation of jobs, economic growth, and additional tax base, the program as currently being implemented by competitive cities will have only limited effectiveness.

Table 5.2 shows the businesses that have received city approval for the enterprise zone credits. As shown, some of the businesses are manufacturing companies that distribute their products to regional or national markets. These companies are more likely to create net growth and jobs for the state. However, some of the firms are commercial and service businesses that are dependent on the local community. These businesses do not stimulate the local economy and generally do not create much net

TABLE 5.2

BUSINESSES RECEIVING LOCAL APPROVAL FOR ENTERPRISE ZONE CREDITS IN COMPETITIVE CITIES

(1983 Designees)*

Name of Business	Location	Project Description
Northland Fleet Service	Mountain Iron	Relocation and expansion of a vehicle maintenance firm.
The Floor to Ceiling Store	Mountain Iron	Relocation of retail tile and fixture store.
American Hockey Stick	Mountain Iron	Start-up of company to manufacture hockey sticks from Minnesota birch.
Nelson-Williams, Inc.	Mountain Iron	Expansion of a mining service firm.
Environmental Energy	Virginia	Expansion of chemical production operations.
Arrowhead Alternative Services	Virginia	Start-up of alternative care nursing home.
Kato Engineering	Mankato	Modernize and reequip engineering company.
Hubbard Milling Company	Mankato	Expansion of milling plant.
Minnesota Quarries	Mankato	Reopen and modernize limestone quarry facility.

Name of Business	Location	Project Description
U.S.A. Veneer	Mankato	Start-up of veneer manufacturing facility.
Vogel Outdoor Advertising	Mankato	Expansion of an advertising firm.
ArtCo. Inc.	Thief River Falls	Expansion of snowmobile manufacturing plant.
Digetkey	Thief River Falls	Expansion of an electronic parts mail order firm.
High Performance Engineering	Thief River Falls	Relocation and expansion of a company that manufactures performance parts for snowmobiles.

Source: Interviews with competitive city officials.

*Includes all businesses approved as of October 1984. As of February 1985, the cities of Minneapolis and St. Paul had not approved any businesses for enterprise zone credits.

growth or jobs for the state. As a result, they should not receive public subsidies. Nevertheless, since the businesses receiving approval fit the statutory eligibility requirements, neither DEED nor the Department of Revenue may refuse final approval of these business applications.

An example of the problem of inadequate targeting is seen in the Mountain Iron/Virginia enterprise zone. In their application for the program, local officials stated that they would allocate credits to businesses offering the most job creation potential, those which leverage the most private dollars to public dollars, and those which will diversify the local economy and reduce the area's reliance on the mining industry. Indeed, a major factor in DEED's decision to designate this enterprise zone was the quality of this development plan. Yet several of the business applications approved by the city councils do not meet *any* of these criteria, indicating that local program goals will not be met.

As with all economic development programs, one should question whether development would have occurred in the program's absence. This issue is particularly relevant in the enterprise zone program since incentives are tied to a particular location rather than the characteristics of the businesses. Most of the businesses receiving local approval to date are expansions of existing city businesses. In some cases, these businesses need to keep operations near each other and are unlikely to undertake their expansions in another state. A few of the other businesses receiving credits are simply relocating their operations from other sites in the designated city or nearby cities while they expand. In these situations, a local business owner is likely to choose an enterprise zone site for an expansion or relocation project over other nearby sites to take advantage of tax reductions. Consequently, it may be that some of the development occurring in the zones would have happened somewhere else within the city or the surrounding area in the absence of the credits. Because city officials are often providing businesses with other financial incentives in addition to enterprise zone tax credits, we believe there needs to be a more careful review of the type of development that is receiving public subsidies for location within an enterprise zone.

In our view, two factors contribute to the problems of inadequate targeting and potential oversubsidization. These include:

- A lack of adequate restrictions in the law against the allocation of state credits to businesses which are not likely to generate jobs or economic growth for the state, and

- Conflicts between local development goals and state economic development goals.

While statutes prohibit distribution of credits to certain types of businesses, the law does not prohibit distribution to retail establishments and certain other businesses that are highly dependent on a local or area economy. In addition, a recent ruling by the Department of Revenue indicates that projects containing less than 25 percent bar and restaurant development are eligible for enterprise zone credits. In our opinion, subsidizing retail businesses, bars, and restaurants will not create jobs for the state. Consequently, a state program of tax credits should not be used to subsidize such businesses.

In a local economy, a retail business can have a positive impact on a city by providing jobs for its residents. This same business is also likely to have a negative impact on competing businesses elsewhere in the area. While it may be in a city's interest to provide a subsidy to a retail business, it is not in the state's best interest to do so. Since it is the cities' responsibility to distribute the credits, however, local goals take precedence over state goals as this program is currently designed.

Recommendations for the Competitive City Program

We believe the competitive city program would be more effective in stimulating economic development with the following changes:

- The Legislature should amend Minnesota statutes to completely restrict competitive cities from distributing enterprise zone credits to retail food and beverage service businesses.

This clarification would help ensure that state development goals rather than local development goals are met through the enterprise zone program. This change could be easily implemented since no credits have been awarded to projects with bar and restaurant uses at this time. In addition,

- The Legislature should consider granting DEED the authority to reject the application of any business that does not meet the goals set forth in the respective competitive city's development plan.

A major factor in DEED's decision to designate cities as enterprise zones is the quality of the development plan. It makes sense that cities should follow the provisions of that plan when implementing their programs. For example, Mountain Iron/Virginia, with goals of diversifying the economy and reducing reliance on the mining industry, should not grant enterprise zone credits to mining service companies. Giving DEED the authority to reject business applications that conflict with the development plans would ensure that both state and local program goals are being met.

To successfully implement this recommendation, DEED would need to shift a small amount of staff resources to review business applications. DEED's budget request for the 1986-1987 biennium requests an additional staff person. In our opinion, one additional staff person is needed but could be shifted from elsewhere in the department.

These recommended changes would be helpful for the existing program but would not completely address our concerns. We believe that more effective control over targeting can be achieved only through a more fundamental change in how the program is administered. Such a change is recommended below in the section on "economic opportunity zones."

b. Border Cities

Border cities face development problems different from those of competitive cities. A border city's service and delivery area is shared with another city in a neighboring state that has significantly lower tax rates. All other factors being equal, businesses will tend to favor locating in the lower taxed city. The border city program is designed to reduce fiscal disparities by providing local Minnesota businesses with tax reductions. In this way, border city officials hope to retain existing businesses and jobs in Minnesota.

For most border cities, 1984 was the first year of implementation, making it is difficult to assess the net impact of the program. Nevertheless, our review indicates that:

- Not all businesses receiving border city credits are negatively impacted by the tax differences or are considering relocating. As a result, the goal of retaining Minnesota businesses may not be met as cost effectively as possible.

- Some businesses seriously considering relocating may not receive enough tax relief through the program to keep them in Minnesota.

- Two border cities are reserving a significant portion of their allocations for new or expanding businesses. This makes the goal of their programs twofold: to equalize the tax burden of existing businesses with that of competing businesses across the border and to encourage development from new or expanding businesses.

The border city program allows any eligible city business to receive tax credits. In the first year of implementation, Moorhead distributed approximately $690,000 in credits to 296 city businesses. Some of these businesses are convenience stores that serve the immediate population. Location is the key to the success of this type of business. Some of these businesses are not subject to out-of-state competition and are unlikely to relocate. As a result, the program may not achieve the goal of business retention in the most cost-effective manner.

When border city tax credits are distributed to a large number of businesses, some businesses seriously considering relocating may not receive enough tax relief to be effective in retaining them in Minnesota. As a result, additional public subsidies may be needed to keep certain businesses in the state.

Some border cities may avoid the problems associated with distributing credits among a large number of existing businesses. We found that two of the designated border cities, Duluth and Breckenridge, are reserving most of their enterprise zone credit allocation for new or expanding businesses. Since a portion of the incentives are targeted to new development, these cities may avoid granting credits to businesses that are not negatively impacted by tax differences and thus not likely to leave the city. Nevertheless, in the event of a proposed relocation, these cities may still award credits to an existing business. Decisions to allocate the credits in this way blurs the distinction between border cities and competitive cities, but the flexibility afforded by the program allows for such variations in local programs.

Regardless of whether credits are distributed to new or expanding businesses, a 1984 change in the method for assessing property hinders the effectiveness of the border city program. To receive border city credits, eligible businesses must have their property designated as "employment property," a special class of commercial and industrial property. Under 1983 guidelines, employment property was assessed at a lower rate than industrial/commercial property, resulting in lower tax burdens for eligible border city businesses. In 1984, the legislature changed the assessment ratios for industrial/commercial property without revising the assessment ratio for employment property. As a result, a portion of the enterprise zone property tax credits is used to equate the assessed value of employment property to that of industrial/commercial class property, negating a portion of the enterprise zone credits' value.

Table 5.3 helps clarify this point. As shown, an industrial/commercial parcel with a market value of $100,000 has a lower assessed value when assessed under the statewide formula than when calculated under the border city employment property formula. This is true for all businesses with market values under $125,000. Consequently, for all small businesses valued under $125,000, a portion of the state and local property tax credits is devoted to equalizing the tax on employment property to that on industrial/commercial property. Since the goal of the program is to reduce the costs of doing business in Minnesota's border cities, this appears to be an inefficient use of enterprise zone dollars.

TABLE 5.3

CALCULATION OF ASSESSED VALUE FOR BORDER CITY BUSINESSES

(Business Property with Market Value of $100,000)

1983 Industrial/Commercial Assessed Value	
34 percent of first $50,000	$17,000
43 percent remainder value	21,500
Total Assessed Value in 1983	$38,500
1984 Industrial/Commercial Assessed Value	
28 percent of first $60,000	$16,800
43 percent remainder value	17,200
Total Assessed Value in 1984	$34,000
Employment Property Assessed Value	
31.5 percent of first $50,000	$15,750
38 percent remainder value	19,000
Total Assessed Value of Employment Property	$34,750

Recommendations for the Border City Program

To improve the effectiveness of the border city program, we recommend the following:

- The Legislature should change the method for assessing "employment property" in border cities so that the entire state-paid property tax credit goes for direct property tax relief.

Such a change would ensure that the state and local funds committed to the border city program are used to accomplish the goals of the program of providing direct tax relief.

Also, we think that border cities can be more selective in granting credits. Some types of businesses, such as convenience stores, will locate in an area because of the immediate population. Such businesses do not receive competition from across the border and should not require incentives to induce them to stay in the border city. We recommend that:

- Border cities should reexamine the distribution of tax credits and target credits to those businesses considering relocation or for which employment is adversely affected by tax differences.

3. ECONOMIC OPPORTUNITY ZONE PROPOSAL

Under current law, no more additional enterprise zones may be designated. DEED is proposing to extend the use of state-paid tax credits through an "economic opportunity zone" program. This new program, if approved by the Legislature, would rely on the same incentives as available through the enterprise zone program. But rather than selecting enterprise zone sites and allowing local governments to distribute the credits, the opportunity zone program would have DEED consider proposals on a project-by-project basis. Consequently, the tax incentives would be potentially available to more Minnesota cities than is the case with the current program.

DEED's proposal would consider the level of distress in a community when evaluating the merit of a submitted proposal, so that economic incentives are targeted to areas in most need of economic recovery. Eligibility would be determined on a sliding scale between the level of distress in the applicant city and either the number of new jobs created by the project or the amount of proposed investment. Thus, a small project creating few jobs would be eligible for the program if the city in which it locates meets all of the distress factors. Likewise, a large project creating many jobs would be eligible even if the city in which it locates meets none of the distress criteria.

In many ways, we believe the economic opportunity zone proposal improves upon the drawbacks of the current competitive zone program. First, since DEED will be reviewing the projects rather than local governments, tax credits can be targeted to those projects that best meet state development goals. Second, the state funds committed to the program can be spread throughout Minnesota rather than concentrating the funds in selected areas of the state. Third, the program will not grant large appropriations to small cities that may lack the capacity to effectively use the funds. Fourth, the sliding scale approach to eligibility allows relief to distressed areas without neglecting the needs of large development projects in other cities.

Nevertheless, we foresee two problems with the program as proposed which should be addressed prior to approval of this program by the Legislature.

- The program as proposed by DEED does not adequately target credits to businesses that stimulate economic growth.

- Accurate estimates of the number of jobs created by projects are difficult to obtain, making it difficult to apply the sliding scale.

The economic opportunity zone proposal incorporates the enterprise zone program's definition of eligibility for receiving opportunity zone credits. This definition restricts businesses like golf courses, automobile sales and service facilities, and entertainment facilities from receiving incentives. As we have pointed out, this definition allows participation by retail and local service businesses, including some retail food and beverage establishments. These businesses do not stimulate the economy and do not generally result in net economic growth for the state.

Project eligibility is further determined by either the amount of capital investment or the number of new jobs projected to be created by the development. Our evaluation of other economic development programs indicates that job estimates are often overstated for several reasons. First, the estimates do not account for potential losses of employment in other businesses that will compete with proposed development. Second, the estimates often include projections of retained jobs in addition to created jobs even though the current positions would not be lost if the expansion did not occur. DEED staff will need to address these factors in order to accurately estimate the job creation potential of proposed projects.

Recommendations

We believe that the economic development potential of the economic opportunity zone program would be improved with the following changes:

- The definition of eligibility under the economic opportunity zone program should be narrowed so that retail businesses, food and beverage establishments, and other firms dependent on a local or area economy are ineligible for the program.

This restriction would help to ensure that incentives are targeted to businesses that stimulate economic growth.

In addition:

- DEED staff should attempt to estimate the number of jobs that would be created by each proposed project. The staff should make efforts to determine the *net* impact of the project on the state economy by considering the effects of competition with other similar businesses in the state.

Implementing this recommendation will require DEED staff to perform more analysis of each project than would be required if the program was adopted as proposed. However, we believe that such analysis is crucial to ensure that state funds are committed to quality projects and that job creation goals are realized.

B. BUSINESS TAX CREDITS

The 1983 Legislature established three tax credits assisting small businesses.

- The *equity investment credit* encourages investment in small businesses by providing investors with Minnesota income tax credits.

- The *technology transfer credit* encourages expansion and innovation by providing a Minnesota income tax credit to businesses that sell or give technology to a small business.

- The *contribution credit* encourages support of certain organizations that assist small businesses by providing a tax credit to corporations and banks making contributions.

These credits were made effective for taxable years beginning after December 31, 1983. Under current law, they are scheduled to expire and will not be available for taxable years beginning after December 31, 1985.

The program is administered by both DEED and the Department of Revenue. DEED determines whether small business and assistance office applicants meet the criteria defined by statute and rules. A taxpayer may not receive credits for investing in a small business or contributing to an assistance office that has not been certified by DEED. In 1984, 34 companies and eight small business assistance offices were certified as shown in Tables 5.4 and 5.5. Applicants must be certified annually to remain eligible. The Department of Revenue processes the tax returns and is responsible for any tax auditing involving these credits.

Implementation of the tax credit program did not begin until after the 1984 legislative session. The Department of Revenue sought amendments to the program, including additional definitions, recapture provisions, and clarifications of acceptable investments. Department of Revenue staff believe that the amendments passed during the 1984 session reduce the potential for abuse of the credits.

In the following sections, we examine each of the three tax credits. Our evaluation is somewhat limited by the relative

TABLE 5.4

QUALIFIED SMALL BUSINESSES CERTIFIED IN 1984

Business Name	Business Description	Location
Applied Membrane Technology, Inc.	Develops, produces and markets membrane products.	Minnetonka
Certified Technologies Corporation	Produces enhanced fire resistance for aircraft interior components.	Minneapolis
Churchill Scientific, Inc.	Develops, manufactures, and markets health care products.	Minneapolis
Comp Equipment Corporation	Produces and markets safety products.	St. Paul
CompuSource Compatible Systems, Inc.	Manufactures and markets microcomputers.	Minneapolis
Coonan Arms, Inc.	Manufactures firearms.	St. Paul
CRC Interior Enterprises, Inc.	Provides upholstery services.	Minneapolis
Deltec Systems, Inc.	Develops and manufactures drug delivery systems.	St. Paul
Dickey Natural Systems	Manufactures lawn and garden fertilizer.	Long Lake
Dimensional Medicine, Inc.	Develops medical electronics.	Minnetonka
Eltrax Systems, Inc.	Manufactures and markets people-carried information systems.	St. Paul
Fox Systems, Inc.	Develops and sells computer software.	Minneapolis
GARN, Inc.	Designs, manufactures and markets energy systems.	Minneapolis
Genesis Labs, Inc.	Designs and manufactures diagnostic assays.	Edina

Business Name	Business Description	Location
Jet Photo International, Inc.	Owns and franchises photo finishing labs.	Bloomington
Knudson/Walters A Personal Service Corp.	Constructs earth homes.	Zimmerman
Megabit Communications, Inc.	Manufacturing operation.	Little Canada
Microtechnology Sources, Inc.	Markets computer software and services.	Eagan
Minnesota Laser Corporation	Manufactures and markets carbon dioxide lasers.	Roseville
Network Communications Corporation	Manufactures electronic instruments.	Eden Prairie
Pattern Processing Technologies, Inc.	Develops elecronic vision pattern recognition systems.	Minneapolis
Prime Energy Products	Manufactures and distributes energy products.	Roseville
Procard, Inc.	Distributes photographic calling cards and brochures.	Bloomington
Renaissance of Golden Valley, Inc.	Provides chemical dependency outpatient services.	Golden Valley
St. Cloud Conversion Corporation	Operates a waste treatment facility.	Minneapolis
Saylors Software First	Retails microcomputer software.	Edina
Sedna Corporation	Develops computer software.	St. Paul
Speed Print, Inc.	Provides commercial printing services.	West St. Paul
Strippers, Inc.	Provides furniture refinishing services.	St. Paul
Surgidyne	Manufactures and sells medical and surgical products.	Minneapolis

Business Name	Business Description	Location
Technology 80, Inc.	Develops and manufactures computers and components.	Minneapolis
Technology Resources, Inc.	Manufactures mechanical equipment.	Plymouth
Video Training Resource, Inc.	Sells video training products.	Edina
Vital Energy Corp.	Provides nutritional analyses and sells nutritional supplements.	Brooklyn Park

Source: DEED.

TABLE 5.5

SMALL BUSINESS ASSISTANCE OFFICES CERTIFIED IN 1984

Organization	Location
Arrowhead Community Economic Assistance Corporation	Virginia
Community Enterprises, Inc.	Duluth
Institute for Invention and Innovation	St. Paul
Minnesota Accounting Aid Society	Minneapolis
Minnesota Cooperation Office	Bloomington
Region II Development Corporation	Bemidji
S.B.D. Inc.	Minneapolis
West Bank CDC	Minneapolis

Source: DEED.

newness of the program. It should be noted that under the Governor's tax simplification proposal these credits would be discontinued.

1. EQUITY INVESTMENT CREDITS

Equity investment credits may be claimed by either individuals or corporations for investing in a certified small business: individuals credit their personal income taxes and corporations credit their corporate income taxes. The investor or any related persons may not own more than 49 percent of the equity stock of the small business in which they invest. To be certified, the business must:

- be a for-profit corporation having its commercial domicile in Minnesota;
- employ 20 or fewer people and have gross annual receipts of less than $1 million in each of its three previous taxable years;
- not be an affiliate or subsidiary of an entity with more than 20 employees or which had total gross receipts for the previous year of more than $1 million, computed by aggregating all the employees and gross receipts of all business entities affiliated with the business;
- derive less than 20 percent of gross annual receipts from royalties, rents, dividends, interest, annuities, and sales or exchanges of stock or securities; and
- not provide licensed professional services, retail food and beverage services, automobile sales and service, or recreation or entertainment, nor be a golf course, country club, tennis club, racquet sport facility, skating facility, racetrack, suntan or hot tub facility, massage parlor, or farm.

The credit equals 30 percent of the net investment made in the equity stock of a qualified small business in excess of $25,000. For example, on a $30,000 investment, the credit would equal 30 percent of $5,000, or $1,500. Investing in several qualified small businesses is permissible, but the maximum credit allowed in one year is $75,000 or 75 percent of the investor's tax liability. If the qualified small business is located in an enterprise zone, the credit increases to 30 percent of the net investment in excess of $10,000 with a $100,000 maximum. If the qualified small business has multistate operations, the net investment is apportioned accordingly. In all cases, the equity investment credit is not refundable. Any remaining credit, however, may be carried over to the next tax year for a maximum of five years.

Under the original 1983 legislation, an investor could have received equity investment credits for transactions which were simply partial transfers of business ownership. Clearly, such transactions do not support economic development goals. The 1984 amendments correct this problem and better target the credits to equity injections that permit business expansion and growth.

Although the 1984 amendments improve the effectiveness of the equity investment credit, we find several problems with the program. First, the program is targeted neither geographically nor by type of firm. The criteria for determining business eligibility are very general and largely related to business size. As a result, investors may receive credits for investing in firms that are unlikely to create economic growth for the state. For example, many types of retail and service businesses are eligible for certification. Among those businesses certified in 1984 is a commercial printing company, a furniture stripping business, a chemical dependency treatment center, a photo finishing firm, and an interior design service. Most of these businesses are highly dependent on the local economy, indicating that they follow rather than stimulate the economy. In addition, existing criteria would allow motels, hotels, and grocery stores to be certified as qualified small businesses, although none have been certified at this time. Investment in these types of businesses are not likely to further state economic development goals.

Second, the net incentive to invest in a qualified small business is somewhat less than the value of the equity investment credit because the investor will probably face an increased federal tax liability in the following year. For a person in a 50 percent federal tax bracket, a 30 percent state investment credit amounts to about a 15 percent total credit after the increased federal tax liability is considered. In that case, the state loses about $2 in tax revenue to provide a net $1 credit to the investor. Finally, the equity investment credit is a tax expenditure item, leaving the state with little control over which companies receive investments, how much investment is made, and how much state revenue is foregone through the credits.

If the Legislature continues the equity investment credit program beyond tax year 1985, targeting should be improved. Investment in retail and certain service businesses should not be eligible for equity investment credits because these investments do little to stimulate the state's economy.

2. TECHNOLOGY TRANSFER CREDITS

Corporations can receive technology transfer credits by transferring a technological process (defined in statute as a proprietary process, formula, pattern, device, or compilation of scientific or technical information) to a certified small business. The technology may be either sold or given the qualified small business, but if it is given, the receiving business must make a substantial investment in developing the technology. Criteria for determining business eligibility for the program is identical to that of the equity investment credit, although the business is not required to be organized as a corporation. Thus, the certified businesses listed on Table 5.4 are eligible recipients of either type of credit.

The maximum allowable credit per year is 30 percent of the first $1 million in net value of the technology or $300,000. Similar to the equity investment credits, any remaining credit may be carried over to the next year for a maximum of five years.

The commissioner of the Department of Revenue must review the technology that is to be transferred, certify its value, and verify that the transferring taxpayer is the undisputed owner. The small business receiving the technology must make a "substantial investment" in acquiring or developing the technology within two years of the date of transfer. "Substantial investment" means that the business must either pay 20 percent of the technology's value in return for acquisition rights (in which case, this amount is deducted from the value of the technology to derive net investment), or the business must spend an equivalent amount for equipment, materials, wages, or other costs to develop, produce, or otherwise use the technology.

It is difficult to draw any conclusions about the technology transfer credit program because it is too early to determine what transfers occurred in 1984.

3. CONTRIBUTION CREDITS

The contribution credit is available to corporations and banks contributing to small business assistance offices or innovation center public corporations. The credit is equal to 50 percent of the first $50,000 contribution.

Similar to the equity investment and technology transfer programs, DEED must certify the small business assistance offices. To be certified, these offices must:

- be a non-profit corporation,
- have the primary purpose of aiding in the formation of new businesses which create jobs by training and assisting business people,
- provide audited financial statements to all contributors and the commissioner of DEED within 90 days following the close of the corporation's fiscal year,

- employ at least two full-time professional employees or the equivalent, and

- not provide financing or be primarily engaged in arranging financing for businesses.

Innovation center public corporations do not need to be certified. These organizations are non-profit public corporations located at a state university. They assist, encourage, develop, and advance small high technology businesses. According to DEED staff, it is not clear what existing organizations would qualify under this definition.

The small business assistance offices certified in 1984 include regional development corporations and community development corporations. Although many of these organizations provide financing to businesses, DEED's rules for the program define financing as market-rate loans. Since these organizations provide below-market-rate financing or equity investments, they qualify for the program.

We wonder whether a tax credit is the best way for the state to support small business assistance offices. With tax credits, the state foregoes tax revenues to benefit assistance offices, but does not retain control over the amount of funding received by various types of organizations or how the funds will be used. If the Legislature sees a need to provide state funding for small business assistance centers, it would be better to provide funding through an appropriation to DEED.

NOTES

[1]Minn. Stat. §273.1314, subd. 9.

Tourism Promotion

Chapter 6

The Legislature increased the budget of the Minnesota Office of Tourism from $2.4 million in the 1982-83 biennium to $8.5 million in the 1984-85 biennium. State tourism officials justified this 250 percent increase on the grounds that it would substantially increase tourism spending in Minnesota. The office's budget request stated that "previous studies indicate that the additional dollars requested for this activity will return, minimally, twice as much in state tax revenues and assist in the generation of new jobs, and generate travel expenditures in a ratio of $43 for every dollar invested."[1] This year the Department of Energy and Economic Development (DEED) and the Governor are requesting a further increase in the tourism office's budget. The request is for $12.2 million during the 1986-87 biennium.

This chapter examines the recent and proposed increases in the state's tourism promotion budget. We first provide some background information on the activities of the Office of Tourism and review the arguments for and against state involvement in tourism promotion. Then, we focus on the following questions:

- Using the best available data, what has been the return to the state from the increase in the state's tourism budget?
- Has increased television advertising in other states been successful?
- How well does the tourism office research and monitor the effectiveness of its advertisements?
- Has the new local joint venture program been successful?
- Is there a sufficient need for the tourism facility loan program proposed by DEED?

A. BACKGROUND

The purpose of the Minnesota Office of Tourism is to stimulate Minnesota's economy by increasing the number of persons who vacation and travel in Minnesota. Its programs focus on tourism promotion, primarily through advertising. It advertises in both print and broadcast media, including newspapers, magazines, television, and radio. These advertisements include toll-free telephone numbers and/or a mailing address so that prospective vacationers can request brochures or information about Minnesota vacation opportunities. The travel information center of the tourism office handles these inquiries and distributes a variety of brochures and maps to the public. The tourism office publishes and distributes 17 publications, including a statewide vacation guide, various activity guides, calendars of events, and directories of resorts, motels, hotels, campgrounds, and restaurants. The tourism office also distributes tourism publications produced by local and regional organizations.

Other activities of the office include promoting Minnesota to convention planners, tour operators, and travel agents. The tourism office also conducts writers' tours and media events to publicize Minnesota vacation opportunities. Finally, the tourism office provides funding to local and regional organizations to increase the quantity and improve the quality of tourism marketing at the local and regional levels.

1. TOURISM OFFICE BUDGET

As previously mentioned, the budget of the tourism office grew from $2.4 million during the 1982-83 biennium to $8.5 million in the 1984-85 biennium. The Department of Energy and Economic Development and the Governor have requested that the office's budget be increased to $12.2 million for the 1986-87 biennium. Table 6.1 summarizes the recent budget increases and the proposed budget increases for the next biennium.

a. Advertising

The activity receiving the largest increase is the advertising budget which grew from $338,000 in FY 1983 to $1,140,000 in FY 1984 and about $1,525,000 in FY 1985. Under the 1986-87 budget proposed by the Governor, the advertising budget would grow to about $2.5 million annually.

b. Travel Information Center and Publications

Increases in advertising generate more telephone calls and mail inquiries to the Travel Information Center which in turn lead to greater distribution of publications to the public. The publication budget grew from $57,000 in FY 1983 to $441,000 in

TABLE 6.1

OFFICE OF TOURISM BUDGET

Fiscal Years 1983 to 1987
(In Thousands of Dollars)

	Fiscal Years				
	Actual		Estimated	Governor's Recommendation	
	1983	1984	1985	1986	1987
Advertising	$ 338	$1,140	$1,525	$2,485	$2,552
Health Care Promotion	0	0	0	250	250
Other Marketing[1]	186[2]	307	385	390	400
Publications	57	441	611	627	656
Other Communications[3]	27[2]	330	390	368	375
Travel Information	327	699	758	978	812
Administration	136	201	194	202	207
Local Joint Venture	0	341	350	350	350
Regional Joint Venture	150	300	300	300	300
Special Joint Venture	0	168	150	150	150
Total Budget	$1,221	$3,927	$4,663	$6,100	$6,052
Staff	13	27	27	27	27

Source: Minnesota Office of Tourism.

[1]Includes staff costs for administering local joint venture program.

[2]During fiscal year 1983, staff costs for communication activities are included under the "other marketing" catetgory.

[3]Includes staff costs for developing publications.

FY 1984 primarily because of the increase in advertising. A portion of the publication budget increase was used for the development of several new publications. The travel information center's budget grew from $327,000 in FY 1983 to $699,000 in FY 1984. The FY 1984 travel information budget included $100,000 to develop a computerized data base. The publication and travel information center budgets increased to $611,000 and $758,000 respectively in FY 1985 to accommodate the expected increase in requests from the public due to increased advertising and other marketing activities.

c. Joint Venture Programs

The tourism office provides matching funds to various organizations involved in tourism promotion through three programs: 1) a local joint venture program, 2) a regional joint venture program, and 3) a special joint venture program. The local joint venture program, which began in FY 1984, is intended to increase and improve tourism marketing by local non-profit organizations. In the program's first year of operation, nearly $350,000 was awarded to local organizations for over 100 projects.

The regional joint venture program is designed to increase and improve tourism marketing at the regional level. Regional non-profit corporations have promoted tourism in Minnesota's six tourism regions since 1968. Currently, there are five tourism regions. During FY 1984, the Office of Tourism provided $300,000 to regional tourism associations on a matching grant basis. The FY 1984 grants included a $60,000 joint advertising campaign developed by the three northern regions of the state, a $30,000 joint advertising campaign developed for southern Minnesota, brochure development, and sport and travel shows.

The tourism office also provides funding to both non-profit and for-profit organizations under a special joint venture program. This program funds projects or activities that the tourism office believes are important to the tourism industry. During FY 1984, the tourism office provided $168,000 in funding for special joint venture projects.

d. Private Contributions

The 1983 Legislature required the Office of Tourism to raise $1 million in private contributions, including no more than $500,000 of in-kind services, in FY 1984 and $1 million in FY 1985 in order to receive the final $1 million of its state appropriations for both fiscal years. For FY 1984, the Office of Tourism raised approximately $2 million in outside contributions. These include 1) a donation of $500,000 in broadcast time from the Minnesota Broadcasters Association in exchange for a $50,000 payment by the Office of Tourism, and 2) the Coca-Cola vacation sweepstakes and discount program which received approximately $800,000 in private contributions. In addition, the office received many other smaller contributions.

2. RATIONALE FOR STATE TOURISM PROMOTION

Supporters of state tourism promotion say that it improves Minnesota's economy by increasing the number of people who vacation and travel in the state. Furthermore, they claim that the state must be involved to achieve collective promotion, which is thought to be more effective than promotion by individual businesses. Advertisements by individual firms focus on increasing their own business rather than increasing the overall amount of travel in the state. Private businesses do not organize to collectively promote the state because the tourism industry is so diffuse and the benefits of statewide promotion are widespread. Tourism promotion advocates also say that tourism is important to the economies of many economically distressed areas of the state, particularly in northern Minnesota. Tourism promotion advocates argue that increased promotion can improve the economies of these areas.

The tourism office promotes Minnesota vacations both to Minnesota residents and to residents of other states and countries. The rationale for attracting people from other states and countries is that they will spend money in Minnesota rather than elsewhere and thus stimulate Minnesota's economy. The rationale given for encouraging Minnesotans to vacation in the state is that they will substitute Minnesota vacations for vacations in other states. The net increase in spending within Minnesota will stimulate the state's economy.

Critics of state tourism promotion raise a number of important concerns. They argue that some of the supposed benefits of tourism promotion come at the expense of other businesses within the state. For example, residents of the Twin Cities metropolitan area may substitute a weekend trip outside the metropolitan area for entertainment expenditures within the metropolitan area. Advocates suggest, however, that even some redistribution of expenditures is desirable because it may help businesses in economically distressed areas of the state.

Critics also question whether benefits gained at the expense of other states will last. Increasing Minnesota's tourism promotion budget may cause other states competing for the same tourists to increase their budgets. The net effect might not be beneficial to any of the states because the impact of their promotional campaigns would offset one another. The state would be spending more tax dollars on tourism promotion without an increase in the number of tourists.

Critics also point out that most of the jobs within the tourism industry are low paying or seasonal jobs. The benefits of tourism promotion, if any, are not likely to have a significant impact on the state's economy. Jobs created in the tourism industry are a poor substitute for higher paying jobs lost in manufacturing, mining, and other sectors of the state economy.

Finally, critics contend that increased tourism can have negative effects on the environment and can require additional public services. These additional public costs should be considered when one weighs the benefits of tourism promotion against the costs.

The issues mentioned by critics raise legitimate concerns. However, there may still be justification for state involvement in tourism promotion. Job creation in the tourism industry, although not as desirable as the creation of higher paying year-round employment, is nevertheless beneficial to the state. The concern about the reaction of other states is an important issue. However, other states and Canadian provinces already advertise in Minnesota. If Minnesota does not advertise and others continue to advertise, Minnesota may lose tourists to other states. The concern that some of the purported benefits of tourism promotion come at the expense of other Minnesota businesses is valid but may not be very significant if the overall benefits of tourism promotion outweigh the costs. Consequently, we believe it is useful to focus the debate on whether increased tourism promotion has produced significant benefits for Minnesota and whether further increases are in the best interests of the state.

B. EFFECTIVENESS OF TOURISM PROMOTION

In this section, we explore a variety of evidence on the benefits of state tourism promotion. First, we review the use of employment, expenditure, and sales data. Proponents of state tourism promotion claim that recent increases in travel expenditures and tourism employment in Minnesota demonstrate that increased state promotion has been successful. We examine whether these data can be used to determine the effectiveness of state tourism promotion.

Next, we examine the tourism office study that concluded that state tourism promotion returned $43 in benefits for each dollar invested during FY 1981. Since we find that study has major limitations, we revise the inquiry method used in the study. We then apply this revised method to FY 1984 data in order to estimate the effect of the recent increase in the state's tourism promotion budget.

1. ANALYSIS OF EMPLOYMENT, SALES, AND EXPENDITURE MEASURES

Tourism promotion advocates point to a number of trends in tourism industry employment, sales, and expenditures as evidence that tourism promotion is effective. In particular:

- Department of Economic Security sample data for the first ten months of 1984 indicate that employment in Minnesota hotels and lodging places increased by 11.7 percent over the same period in 1983. Similarly, employment in eating and drinking places increased by 8 percent over the same time period.

- The United States Travel Data Center estimates that, between 1982 and 1983, travel expenditures increased by 11.4 percent in Minnesota compared to a 7.3 percent nationwide increase.[2]

- Gross sales for Minnesota hotels, motels, and lodging establishments increased by 18.2 percent between 1982 and 1983, compared to an increase of 7.3 percent for the nation. Sales grew by 23.9 percent in Minnesota between the first three months of 1983 and the first three months of 1984. The comparable national growth rate was 12.9 percent.[3]

- According to estimates made by the Bureau of Business and Economic Research, University of Minnesota, Duluth, tourism expenditures in Duluth increased by 9.4 percent and lodging receipts in Duluth increased by 17 percent between the first 8 months of 1983 and the first 8 months of 1984.

Some of the above cited figures are for time periods prior to the large increase in the tourism office's budget. That increase first became available on July 1, 1983. However, state tourism officials point out that they made several changes to increase Minesota's advertising exposure both within and outside of Minnesota prior to the availability of the increased funds. The office reduced its fall 1982 and winter 1983 advertising in order to increase the advertising budget for the spring-summer 1983 campaign. In addition, the office initiated its Explore Minnesota campaign and arranged for private promotional activities such as the Coca-Cola promotion and sugar packet advertising. Consequently, state officials suggest the impact of increased state promotional activity could show up as early as the spring and summer of 1983.

The figures cited by advocates appear to indicate that spending by travelers is increasing in Minnesota and favorably influencing state employment. However, the following data limitations make it difficult to determine whether these increases are due to increased tourism promotion by the state:

- National employment data comparable to Minnesota's data are not available.

- Comparative lodging sales data for Minnesota and the nation were only available through March 1984 (as of December 1984). Comparative expenditure data are available only through the end of 1983. Thus, the effects of the major budget increase for the 1984 spring-summer advertising campaign are not yet reflected in the data.

- It is not possible to separate the effects of tourism promotion from many other factors which affect tourism or travel spending, such as changing vacation preferences and changing business travel patterns.

- Estimates made by the United States Travel Data Center assume that the percentage of restaurant business attributable to tourism does not change over time.

Employment data are the least reliable indicator because there are not comparable national data. Expenditure and lodging sales data from the United States Travel Data Center show faster growth in Minnesota than the national average. However, these data do not demonstrate that state tourism promotion has been successful. There are many factors besides tourism promotion that affect these measures. These factors include changes in the state and national economies, business travel, the weather, changes in consumer preferences, development of tourism attractions, and general publicity about the state. For example, a relative increase in business travel within Minnesota could explain some of the additional growth that has occurred in Minnesota. Furthermore, a greater increase in local restaurant business in Minnesota compared to elsewhere could explain the difference in Minnesota and national travel expenditures. The United States Travel Data Center does not know how much of the increase in a state's restaurant business is due to greater expenditures by tourists and how much is due to increased dining by local residents. The center assumes that the percentage of restaurant business attributable to tourism does not change over time. However, if the restaurant business in Minnesota is expanding more than elsewhere due to increased dining by local residents, then the center's data would be misleading. The additional growth in Minnesota would not be attributable to increased tourism.

In summary, the evidence cited by advocates is encouraging but not conclusive. Since there are so many factors that can affect available measures of travel expenditures and lodging sales, it is difficult to distinguish the impact of increased tourism promotion and other factors. Also, data for the time period most affected by the recent increases in the state tourism budget were not available at the time this report was written.

2. RETURN ON INVESTMENT ESTIMATES BASED ON TOURISM OFFICE INQUIRY DATA

According to the 1984-85 biennial budget request prepared by state tourism officials, previous studies indicated that additional tourism dollars "generate travel expenditures in a ratio of $43 for every dollar invested." During the 1983 legislative session, tourism officials say they attempted to clarify that the $43 estimate was the average return to tourism promotion during fiscal year 1981 and not an estimate of the return the state could expect on additional investment in tourism programs. Nevertheless, we believe that it is important to examine this study because the results of the study were widely reported and there appears to be confusion over what the $43 return on investment represents.

The tourism office study estimated the 43:1 return on the basis of the results of follow-up surveys sent to persons who had requested travel information from the tourism office during FY 1981. After the fall, winter, and spring-summer seasons of that year, the office surveyed a random sample of persons who requested brochures during the season. The survey asked people whether they had vacationed in Minnesota and how much they had spent in Minnesota. The estimate of dollars generated by tourism promotion was calculated by multiplying the total number of inquiries for each season times the proportion of those surveyed who said they had vacationed in Minnesota times the average dollars those surveyed said they had spent in Minnesota.

This method had several major limitations that make it an inappropriate measure of the return the state could expect on additional investment in tourism programs:

- The study did not measure the marginal return from increased state spending on tourism promotion. At best, it could have measured the average return on those dollars spent during FY 1981. The return from increased spending would likely be smaller because each additional dollar of advertising will tend to provide diminishing returns.

- The study failed to consider the effect of non-response bias and thus substantially overestimated the percentage of persons who vacationed in Minnesota. The results were based on responses to a single mailing. Literature on tourism advertising indicates that persons who respond to the initial mailing are significantly more likely to have vacationed in the area being advertised than non-respondents.[4]

- The study assumed that all persons who said they had vacationed in Minnesota had come as a result of the office's tourism promotion campaign. As a result, the study overestimated the return on investment because many would have undoubtedly vacationed in Minnesota regardless of the tourism promotion campaign. Literature indicates that many people decide to vacation in an area before they request information about that area. Furthermore, even for those who did not decide until after receiving tourism brochures, it is difficult to measure how much influence the brochures and advertising had on their vacation planning.

- The study did not consider other factors that would have resulted in a higher estimated rate of return. For example, the study did not attempt to measure how many people vacationed in Minnesota as a result of the state's advertising campaign even though they did not request information from the tourism office. In addition, the study did not attempt to measure future benefits due to repeat visits or word of mouth advertising.

3. MODIFIED INQUIRY-CONVERSION METHOD

The literature on tourism advertising indicates that the inquiry-conversion method used by the Office of Tourism can be improved by reducing non-response bias and by counting only those vacationers whose decision to vacation in a particular area was actually influenced by the advertising or brochures.[5] Adjusting for these factors, we were able to estimate the average return on advertising during FY 1984. In addition, we attempted to estimate the marginal return resulting from the increased advertising that occurred between FY 1983 and FY 1984.

To obtain an estimate of average return on investment for fiscal year 1984, we first estimated expenditures in Minnesota by travelers whose decision to vacation in Minnesota was influenced by the information received from the tourism office. Tourism expenditures influenced by tourism promotion efforts during fiscal year 1984 were estimated to be between $32.4 and $36.4 million. These expenditures were then divided by the cost of advertising, printing publications, and operating the Travel Information Center, which handles mail and phone inquiries and distributes publications. During FY 1984, these costs totaled $2,270,000. The average return to tourism advertising during FY 1984 was calculated by dividing tourism expenditures of $32.4 to $36.4 million by costs of $2,270,000. The estimated average return is between $14.30 and $16.00.[6]

It is more important to estimate the marginal return to the state. The marginal return is the amount of increased tourism expenditures in the state per additional dollar spent on tourism promotion. Decisions about the effectiveness of tourism promotion should focus on the marginal return and not the average return. For example, the average return could be 15:1 while the marginal return was less than 1:1. A marginal return of less than 1:1 indicates that the last dollar spent on promotion returned less than one dollar in benefits.

To calculate the marginal return from recent increases in the tourism budget, we first estimated the increase in spending by tourists persuaded by the advertising campaign and brochures. We estimate that between $7.9 and $9.3 million in additional tourism spending occurred as a result of the increased tourism advertising during FY 1984. This is an increase of approximately 33 percent from the previous year. The percentage increase is about equal to the 36 percent increase in inquiries received by the Office of Tourism during the year ending July 31, 1984. We calculated the marginal return by dividing tourism expenditures of $7.9 to $9.3 million by the additional costs of advertising, publications, and operation of the Travel Information Center. These costs were $1,548,000 during FY 1984. The estimated marginal return is between $5.10 and $6.00 per dollar of increased spending by the tourism office. Table 6.2 summarizes the results of our analysis of marginal and average rates of return.

It should be emphasized that even the more sophisticated methods we employed are not able to capture all of the factors one would want to consider. For example, we assumed that the entire increase in inquiries was caused by the increase in advertising. It could be argued that a portion of the increase in inquiries was due to a general upturn in the economy and in tourism. In addition, our analysis counts all travelers who said that tourism publications helped them decide to vacation in Minnesota. We did not attempt to measure how much influence the advertising and brochures had on them. We simply assumed that the state's tourism promotion efforts caused them to vacation in Minnesota. It could be argued that the marginal and average returns are actually less than our estimates, since we did not attempt to account for these factors.

Others could argue that our estimates are too low. Tourism promotion may influence people to vacation in Minnesota even though they do not request additional information from the Office of Tourism. Our analysis and most others in the literature count only those people who contact the office mentioned in advertisements. This may be a reasonable assumption since it is likely that most people who are persuaded by the advertising will contact the office for information. However, it is not known how many individuals who are persuaded do not contact the office. In addition, persons who vacation in Minnesota because of the advertising may come back again to Minnesota or influence friends and relatives to vacation in Minnesota. Little is known about these future benefits in Minnesota or elsewhere. Since

TABLE 6.2

RETURN ON INVESTMENT IN TOURISM PROMOTION: YEAR ENDING JULY 31, 1984

Inquiry Conversion Method

	Total Inquiries	Expenditures in Minnesota by Travelers Influenced by Brochures	Cost of Advertising, Publications, and Travel Information Center[1]	Average Cost Per Inquiry	Estimated Average Return on Investment
Minn. Residents	101,588	$11.9-$12.9 million			
Other States	107,745	10.9- 13.1 million			
Walk-In Visitors	49,577	5.8- 6.3 million			
No Brochure Calls	29,402	3.4- 3.7 million			
Other	3,421	0.3- 0.4 million			
Total	291,373	$32.4-$36.4 million	$2,270,000	$ 7.79	$14.30-$16.00
Additional Inquiries Over Previous Year					
Minn. Residents	11,428	$ 1.0 million			
Other States	51,073	5.2- 6.2 million			
Walk-In Visitors	2,166	0.2- 0.3 million			
No Brochure Calls	13,242	1.5- 1.7 million			
Other	109	0			
Total	78,018	$7.9-$9.3 million	$1,150,000	$19.23	$5.30-$6.20

our estimates do not include these future benefits, it could be argued that our estimates are too low.

4. CONCLUSIONS

The best available evidence suggests that the additional state spending on tourism promotion authorized by the 1983 Legislature has generated about $5 in benefits per dollar spent. Overall, tourism advertising in FY 1984 had an average return of 15:1. Some conclusions can be drawn from these results. First, tourism promotion appears to help the state's economy. Second, investing more funds into tourism promotion does not generate as much return as was already attained. Increased advertising for FY 1984 influenced about $5 in tourism spending per dollar invested compared to an overall average of $15 during FY 1984. Finally, it is not clear whether all funds generated a return large enough to justify the expenditure of state funds. It is likely that some portions of the additional spending that occurred during FY 1984 had a return of greater than 5:1 and others less than 5:1. It is important to examine the marginal return for various portions of the increased tourism budget in order to determine if any portions generated a very low return. In the next section of this chapter, we examine the office's television advertising campaign in detail and find that some portions of the campaign may have generated very low returns.

C. EFFECTIVENESS OF THE TOURISM OFFICE'S TELEVISION ADVERTISING CAMPAIGN

A major component of the 1984 spring-summer advertising campaign was $193,000 in TV advertising supported by $57,000 in newspaper advertising in six midwestern metropolitan markets--Chicago, Kansas City, St. Louis, Quad Cities, Omaha, and Des Moines. Producing the two commercials used in this television campaign cost an additional $70,000.

1. MEASURING ADVERTISING EFFECTIVENESS

To measure the effectiveness of this campaign, the tourism office arranged to have two studies conducted in addition to collecting the regular inquiry data.

- The first study surveyed awareness of Minnesota advertising and Minnesota's image as a vacation state before and after the 1984 advertising campaign in each of the six television markets.

- A second study will examine how Minnesota's share of the summer vacation market changes between 1983 and 1985 in Chicago, several Iowa cities, and eastern Nebraska.

The results of the first study were mixed. It found significant increases in awareness of Minnesota advertising but no significant image changes for Minnesota. The percentage of respondents who recalled seeing Minnesota's advertisements increased from nine percent to nineteen percent after television ads were run. However, in response to an open-ended question that asked respondents to identify the states they were likely to visit in the near future, the percentage choosing Minnesota remained the same before and after the television advertising campaign. When respondents were asked how likely they were to vacation in Minnesota, Michigan, Illinois, or Wisconsin, the percentage saying they were very or somewhat likely to vacation in Minnesota increased slightly from 25 percent to 29 percent.[7]

The second study will attempt to measure the change in Minnesota's market share in Chicago and several Iowa cities. In fall 1983, a study sponsored by a private corporation measured Minnesota's share of the vacation market in these cities. The tourism office plans to conduct a similar survey in fall 1985 to measure the change in Minnesota's share of the vacation market in these cities. This type of comparison could be valuable, but the sample size in the initial study was probably too small to accurately measure changes in the Chicago market.[8] A sample should be large enough so that the survey can detect expected changes in vacation behavior. One reason the sample size was small was that the survey was very long, taking a half hour to complete. The tourism office should consider conducting another short survey now with a larger sample size. It may not be too late to obtain baseline data since respondents should be able to recall long vacations taken in the past two years. Otherwise, the results of the second study may not be useful.

2. MARGINAL RETURN FROM TELEVISION ADVERTISING

Another method of measuring the effectiveness of the television advertising campaign is to calculate an estimated marginal return. The return could be calculated in a manner similar to that we used in the previous section of this chapter. The results of the office's survey of inquirers could be used to calculate the percentage of inquirers who subsequently vacationed in Minnesota and were persuaded to vacation here because of the state's advertisements and brochures.

One of the limitations of inquiry data is that the data do not include persons who vacation in Minnesota because of the advertising even though they did not contact the tourism office. This may be more significant for television advertising than for newspaper and magazine advertising. Television advertising is designed to increase awareness of Minnesota vacation opportunities by itself and may rely less on inquiries and brochures than newspaper and magazine advertisements. In addition, television advertising may be more likely to have cumulative effects over time. Nevertheless, we believe that it is useful to examine inquiry data for television campaigns. If television advertising would generate reasonably high returns based on inquiry data, this information would be valuable. If on the other hand, it generated very low returns, it would be reason to be concerned. It would demonstrate the need to collect good market share data and watch future trends to see if the results improve with time.

We have estimated the return on the state's television advertisements in Chicago and five other midwestern cities. These results are presented in Table 6.3. The return on investment was calculated by dividing the estimated tourism expenditures in Minnesota by the costs of the advertising campaigns. Cost figures include actual media costs and the estimated cost of printing publications and operating the Travel Information Center. The campaign also spent $70,000 to produce the two television commercials used in the campaign. The cost figures do not include this one-time production cost because these commercials can be used in other campaigns. The estimates of tourism expenditures were obtained by multiplying the actual number of inquiries to television ads from a particular area by estimated expenditures per inquiry. Since the results of the spring-summer 1984 survey of non-Minnesota inquirers were not available, we used the spring-summer 1983 survey of non-Minnesota residents to calculate the estimated exenditures per inquiry. We followed the same methods used in calculating the results contained in Table 6.2.

For television inquiries, the cost per inquiry is very high and the return on investment is very low. The cost per inquiry ranges from $84 to $317. The estimated overall return on investment was less than $1 per dollar invested. These results are presented in the top half of Table 6.3.

Tourism office management contends that these results may be misleading because it is difficult to remember a telephone number on a television screen. Consequently, many persons may have vacationed in Minnesota because of these television advertisements but did not contact the tourism office. Also, many inquiries could have been influenced by a television advertisement but could not be traced to the television advertisement. For example, many persons who called or wrote to the Tourism Office may have been influenced by a television advertisement and subsequently found the telephone number or address in a newspaper ad that supported the television campaign. As a result, tourism officials believe that television and newspaper advertisements should be viewed as a package. Furthermore,

TABLE 6.3

ESTIMATED RETURN ON INVESTMENT FOR 1984 SPRING-SUMMER TELEVISION CAMPAIGN

Inquiry Conversion Method

Market	Inquiries	Estimated Expenditures in Minnesota by Travelers Influenced by Brochures	Cost of Advertising, Publications, and Travel Information Center	Cost Per Inquiry	Return on Investment
Television Only					
Chicago	868	$ 89,400-$108,800	$ 98,600	$114	$0.91-$1.10
Kansas City	153	15,800- 19,200	34,400	225	0.46- 0.56
St. Louis	205	21,100- 25,700	45,700	223	0.46- 0.56
Quad Cities	46	4,700- 5,800	14,700	320	0.32- 0.39
Omaha	229	23,600- 28,700	20,200	88	1.17- 1.42
Des Moines	171	17,600- 21,400	15,500	90	1.14- 1.38
Total	1,672	$172,200-$209,700	$229,100	$137	$0.75-$0.92
Television and Newspaper Combined					
Chicago	2,327	$240,000-$292,000	$128,960	$ 54	$1.86-$2.26
Kansas City	551	57,000- 69,000	46,918	85	1.21- 1.47
St. Louis	889	92,000- 111,000	62,829	71	1.46- 1.77
Quad Cities	147	15,000- 18,000	21,630	147	0.690 0.83
Omaha	451	46,000- 57,000	29,368	65	1.57- 1.94
Des Moines	942	97,000- 118,000	27,068	29	3.58- 4.36
Total	5,307	$547,000-$668,000	$316,773	$ 60	$1.73-$2.10

during the spring-summer season, the tourism office received over 19,000 mail inquiries from Minnesota and elsewhere which could not be traced to a particular advertisement, nearly 6,000 phone calls from persons in Minnesota and elsewhere who said they obtained the number from the telephone company's information service, and over 11,800 inquiries from Minnesota and elsewhere that were prompted by referrals from other persons. These three categories account for nearly 20 percent of all inquiries received during that season. State tourism officials believe some of these inquiries could have been influenced by the television advertisements.

We are skeptical that television advertising generated many inquiries other than those directly traceable to television ads. For example, the number of newspaper generated inquiries fell significantly in 1984 in each of the six television markets even though the 1983 newspaper ads were not supported by television advertising (see Table 6.4).[9] As a result, we do not believe that many people were influenced by television ads but responded to newspaper ads. Even if newspaper and television advertising is treated as a package, the cost per inquiry was still high, ranging from $29 per inquiry in Des Moines to $147 in Quad Cities. The cost per inquiry from the Chicago area was $54. The estimated overall return is between $1.73 and $2.10 per dollar spent. These results are presented in the bottom half of Table 6.3.

To determine whether television advertising generated a large number of inquiries that could not be traced to a particular advertisement, it would be useful to examine whether states with television ads had an unusually large increase in such inquiries. These data are not yet available. The best available alternative for the Chicago market is to compare the change in total inquiries from Illinois from 1983 to 1984 with the change in comparable states that had no television advertising. Indiana and Wisconsin are the best comparison states because the tourism office advertised extensively in newspapers from all three states in 1983 and there was a large decline in newspaper inquiries from all three states in 1984. Between 1983 and 1984 total inquiries declined by 12 percent for Wisconsin and increased by 2 percent for Indiana (see Table 6.5). Since Wisconsin and Indiana experienced somewhat larger declines in newspaper inquiries than Illinois, one would expect Illinois to have at least maintained its 1983 inquiry level in 1984, if the tourism office had not advertised on television in Illinois.[10]

Assuming that the full increase of 2,054 inquiries in Illinois was due to television advertising in Chicago, the cost per inquiry would still be nearly $50. The return on investment would be just over $2 in tourism expenditures per dollar invested.

In summary, the inquiry data do not support the effectiveness of television advertising. However, it is too early to conclude

TABLE 6.4

COMPARISON OF NEWSPAPER INQUIRIES IN TELEVISION MARKETS

1983 vs. 1984

	1983 Spring-Summer Campaign			1984 Spring-Summer Campaign		
	Media Cost	Inquiries	Cost Per Inquiry	Media Cost	Inquiries	Cost Per Inquiry
Chicago	$24,078	4,936	$ 4.88	$22,730	1,459	$15.65
Des Moines	8,308	1,461	5.68	8,622	771	11.19
St. Louis						
Globe Democrat	11,587	584	19.84			
Post/Dispatch	8,162	1,227	6.65	14,454	684	21.13
Kansas City	6,969	677	10.29	10,946	398	27.51
Omaha	6,725	1,200	5.60	8,313	222	37.45
Quad Cities	3,049	413	7.38	6,501	101	64.37

Source: Minnesota Office of Tourism.

TABLE 6.5

INQUIRIES BY STATE

March 1-July 31, 1983 and March 1-July 31, 1984

	1983	1984	Percent Change
TV Market States			
Illinois	8,734	10,788	+23.5%
Iowa	3,797	6,999	+84.3
Missouri	2,523	3,840	+52.2
Kansas	1,089	1,528	+40.3
Nebraska	1,547	2,049	+32.4
Sub-Total	17,690	25,204	+42.4%
Non-TV States			
Wisconsin	5,961	5,201	-12.7
South Dakota	673	1,298	+92.9
North Dakota	1,015	1,486	+46.4
Indiana	2,529	2,575	+ 1.8
Michigan	1,199	3,179	+165.1
Other States	11,364	39,929	+251.4
Sub-Total	22,741	53,668	+136.0%
Total Non-Minnesota	40,431	78,872	+ 95.1%

Source: Minnesota Office of Tourism.

that television advertising cannot be effective in these markets for several reasons. First, persons may be influenced by television ads to vacation in Minnesota but not contact the Tourism Office for travel information. The planned surveys in the television market areas may help address this issue if properly conducted. Second, the awareness of non-Minnesota residents of Minnesota's advertising has increased even though television advertising may not have significantly influenced the vacation plans of non-Minnesota residents. It may take time to affect actual vacation decisions. This was the first year of television advertising. It may take repeated exposure to be effective. Finally, the tourism office plans to make several changes in its 1985 Chicago television campaign to improve the results. It will increase the time the telephone number is on the screen, add billboard support to the campaign, place greater emphasis on Minnesota as an outdoor attraction in the advertisements, and change the time when the ads appear so as to reduce direct competition with other states' advertising in Chicago.

The Office of Tourism has requested a sizeable increase in its 1986-87 biennial appropriation in order to increase the amount of advertising outside of Minnesota. State tourism officials tell us they would direct much of the increase at the Chicago market. In light of the results of our analysis, we recommend that:

- The 1985 Legislature should carefully review whether the Office of Tourism should expand its advertising in Chicago or elsewhere outside Minnesota.

By early April of 1985, the Office of Tourism should have some preliminary results on the number of inquiries generated from Chicago and elsewhere outside Minnesota during FY 1985. These results may be helpful in guiding the Legislature's decision. If the Office of Tourism is permitted to continue or increase its advertising outside Minnesota in the next biennium, the return on investment should be calculated and presented to the Legislature in 1986 and 1987.

D. PLANNING AND RESEARCH ACTIVITIES

Effective tourism promotion depends on:

- Identifying the most promising markets,
- Developing a strategy to reach these markets,
- Developing quality advertisements and brochures, and
- Monitoring the effectiveness of the promotions.

The Minnesota Office of Tourism is involved in each of these activities. The office sponsors market research or uses existing research to determine who are Minnesota's current tourists and to determine interest in Minnesota vacations by potential new tourists. The office has developed strategies for reaching a variety of markets. For example, it reaches persons interested in fishing through fishing magazines in addition to conventional newspaper advertisements emphasizing Minnesota's outdoor attractions. It reaches the bus tour market by attending trade shows involving bus tour operators, advertising in trade journals, working directly with bus tour operators, and conducting occasional tours to acquaint these operators with Minnesota's attractions.

To develop effective brochures, the office holds group meetings with vacationers to find out what information they want in a brochure and what they think of existing brochures. As a result of these focus groups, the tourism office redesigned its brochures during 1984.

The office also monitors the effectiveness of its advertisements. The primary method for monitoring the effectiveness of its advertisements is through the use of inquiry data. All telephone callers are asked what advertisement prompted their call, and write-in coupons are pre-coded according to the advertisement in which they appeared. The office's computer tabulates the number of inquiries for each advertisement. Staff can then calculate the cost per inquiry for each advertisement to help plan future advertising campaigns.

We believe the Office of Tourism conducts many of these planning and research activities effectively. However, improvement is needed in the following areas:

- The Office of Tourism needs to improve its analysis of the effectiveness of promotional campaigns.
- The office needs to develop a marketing strategy for the business traveler market.

1. ANALYSIS OF PROMOTIONAL EFFECTIVENESS

In general, the Office of Tourism needs to make a more objective assessment of the return from its various promotional campaigns. The office typically calculates the cost per inquiry generated by each advertisement. Staff use cost per inquiry information when planning future advertising campaigns and deciding which campaigns should be continued.

Examining cost per inquiry data can be useful, but it has limitations. First, it would be inappropriate to assume all inquirers vacation in Minnesota. Many who receive brochures vacation elsewhere. Also, some who vacation in Minnesota would have done so regardless of the state's advertising campaign. Second, travel research indicates that, among persons who make an inquiry, the percentage that actually vacation in the desired state or region varies significantly by the city in which the advertisement appeared.[11] As a result, comparing the cost per inquiry of different advertisements can be misleading. An advertisement with a low cost per inquiry could have a high cost per person who inquires and actually vacations in Minnesota.

After each advertising season, the tourism office surveys a sample of those people who inquired during that season. The survey asks whether the inquiring parties actually vacationed in Minnesota. Until recently, the survey also asked whether the brochures sent to the inquirers helped them decide to vacation in Minnesota.

These questions could be used by the tourism office, as we have done earlier in this chapter, to calculate the return to particular advertisements or advertising campaigns. In calculating the return, inquirers who did not vacation in Minnesota and those who did but were not influenced by the advertising should not be counted. In addition, the results need to be adjusted for non-response bias so that the return is not overstated. Beginning in 1983, the tourism office reduced non-response bias by using two mailings instead of one mailing. Since the literature indicates that non-response bias for surveys with two mailings can still be significant, the tourism office needs to do more analysis of non-response bias to improve the accuracy of the survey results.

We recognize that it is not practical to use the survey results in this way for every advertisement. The office's survey is based on a random sample of inquiries. As a result, the sample size is inadequate for analyzing those individual advertisements that do not generate large numbers of inquiries. Currently, however, the survey data is only broken down into two geographic areas: Minnesota and all other states. This does not adequately reflect the difference across the nation or across different types of advertisements. Since the office is now advertising outside of Minnesota much more than in the past, it is important that the survey results for non-Minnesota inquiries be examined more closely.

We recommend that:

- The Office of Tourism should utilize the survey results to calculate a return on investment for major advertising campaigns, particularly those conducted outside Minnesota.

- For smaller campaigns that generate few inquiries and few survey responses, the return could be estimated by multiplying the number of inquiries for that campaign times the average tourism spending in Minnesota per inquiry for a larger but comparable group of inquiries.

- The return should exclude those inquirers who did not vacation in Minnesota and those who did but were not persuaded by advertising or brochures. The results should be adjusted for non-response bias.

- The tourism office should closely examine how its advertisements and brochures influence inquirers. Based on this research, it should devise a question or questions that measure the influence of brochures and advertisements on tourist spending in Minnesota. These questions should be included in the office's regular survey of inquirers.

It is important for state government officials to know what return the state is getting on its greatly expanded tourism advertising campaigns. There are a great number of programs competing for the limited dollars the state spends on economic development. It is important to know whether the expanded tourism efforts have been worth the cost and should be continued or expanded. In order to provide some oversight of the tourism office's implementation of our recommendations, we recommend that the Policy Analysis Division of the Department of Energy and Economic Development review the methods used by the Office of Tourism to calculate a return on the state's investment.

2. BUSINESS TRAVEL STRATEGY

One market for which the tourism office has not yet developed a marketing strategy is the business traveler market. However, the tourism office arranged for two studies sponsored by National Car Rental to assess the business traveler market. These studies and the large volume of business travel in Minnesota suggest that this is a promising market. Currently, the tourism office relies primarily on other organizations to distribute one-page brochures that prospective vacationers can use to request additional information from the tourism office. State tourism officials say they plan to develop a marketing strategy to reach business travelers.

We agree that the tourism office should develop a marketing strategy for reaching business travelers. This strategy should focus on: 1) promoting vacation opportunities to known business travelers so that they extend their stay in Minnesota and 2) promoting Minnesota to potential business convention participants in order to increase convention attendance as well as extended vacations. The tourism office should experiment with several different promotional techniques in situations in which prospective business convention participants are known in advance. Subsequent evaluation of those techniques should help the office identify the ones that appear to be most successful.

E. LOCAL JOINT VENTURE TOURISM PROGRAM

The Office of Tourism created a local joint venture program in FY 1984 to increase tourism marketing by non-profit organizations throughout Minnesota. The tourism office awards grants of up to $5,000 provided that the grant does not exceed the private sector contribution to the project. In FY 1984, the tourism office awarded nearly $350,000 to over 100 projects.

Under the local joint venture program, state funds are used for the following marketing activities:

- Promoting community festivals, celebrations, or events;
- Advertising an area's vacation opportunities;
- Printing and distributing publications or brochures promoting tourism in Minnesota communities.

Advertising must be placed in new markets that are at least 50 miles away from the community or in other states. Brochures must be new or updated and must be distributed at least 50 miles from the community. Four-color brochures are given priority. Applicants cannot receive funds for the same project in future years.

State tourism officials attempt to target funds to projects that would not otherwise occur and that would be supported by local funds in future years if they are successful. This policy is appropriate although it is inherently difficult for a grant program to avoid funding some projects that would otherwise occur. For example, most communities will eventually update their brochures on their own. The effect of the program is probably to accelerate this task and often to improve the quality of the brochures.

One problem with the program is that it sometimes funds projects that support local objectives but do not effectively promote state tourism objectives. The tourism office policy to not fund any promotion in Minnesota communities less than 50 miles from the applicant's community helps prevent funding projects which do not promote state tourism objectives. However, we believe that the program's guidelines do not go far enough. From a local point of view, any additional tourists help the local economy. But from the state's point of view, increasing tourism in one community at the expense of other communities does not help the state's economy. Furthermore, increasing tourism within the state by Minnesota residents may merely increase spending in the tourism sector of Minnesota's economy at the expense of other sectors of Minnesota's economy.

From the state's point of view, promotion would be more effective if it featured a variety of vacation opportunities and attractions, including those of nearby communities rather than single events or single communities. For example, advertising which attracts one or two day trips by Minnesota residents to a community event may help the local economy but it would be less likely to help the state's economy. These short trips are more likely to be substitutes for local recreational activities than for out of state travel. Furthermore, joint advertising by several nearby communities with similar or complementary attractions would usually be more effective than separate advertising by each individual community. Consequently, we recommend that:

- The tourism office should revise its guidelines on local joint venture grants in order to give the greatest priority to projects that best promote state tourism objectives. Priority should be given to: 1) projects that can effectively attract additional tourists from other states, and 2) brochure or advertising proposals that feature the attractions of an entire vacation destination area.

The local joint venture program is designed to encourage new local marketing activities by helping to finance the first year's costs. The success of projects that advertise in new markets depends on whether the applicant continues advertising in those markets in subsequent years. The program requires each grant recipient to evaluate the success of its project. However, since these evaluations are to be completed soon after the project is completed, they will not generally indicate whether the project will be funded locally in future years.

In a few instances, the tourism office has funded the promotion of one-time community events or celebrations that are not expected to continue. However, in most cases, it is important to the success of the program to know whether marketing projects have continued without state support. As a result, we recommend that:

- The Office of Tourism should require grant recipients to report on whether marketing activities initially funded by the state have been continued in subsequent years.

This additional reporting, when combined with the required evaluation, should give state tourism officials and others a better basis on which to judge the success of this program. If a significant number of grant recipients do not continue these marketing activities beyond the first year, state tourism officials should either devise ways to improve the program or discontinue it.

F. PROPOSED TOURISM LOAN PROGRAM

Currently, the Office of Tourism does not provide financial assistance for the private development or improvement of tourism facilities. However, the Department of Energy and Economic Development is considering a $2 million tourism loan program financed by the Economic Development Fund. According to the department's preliminary plans, the program would provide up to $50,000 in low interest loans to finance resort or campground development and renovation. To be eligible for the program, applicants must obtain bank financing equal to or greater than the loan amount to be received from DEED. To protect the security of the loans, the bank and DEED would share first position on the mortgage. Before deciding whether to implement this program, DEED is waiting to analyze the results of a survey of Minnesota resorts sponsored by the Minneapolis Star and Tribune.

Advocates of tourism loan programs argue that tourism can be increased by expanding and improving lodging and support facilities. Improvements can include a general upgrade of the existing facilities, adding amenities, or making the resort suitable for winter tourism. Loan program advocates claim that tourists are demanding higher quality facilities and that the private sector is not adequately responding to the demand for two reasons. First, many resorts are said to have difficulty raising capital to make improvements that are financially sound. Resort owners often do not have sufficient income to substantially improve their facilities through reinvestment. They often purchased the resort under a contract for deed and consequently find it difficult to offer the bank adequate collateral on a loan. Second, it is claimed that public subsidy is necessary to make marginal projects feasible and that the public benefits of these projects justify the public subsidy.

Evidence supporting these arguments consists primarily of testimonial evidence by people familiar with tourism in the state. There is also some empirical evidence that the resort industry is declining in Minnesota. According to Minnesota Department of Revenue data summarized by the Office of Tourism, the number of resorts in Minnesota has been declining during the last ten years. In addition, lodging receipts in northern Minnesota grew at a slower rate than inflation during the last ten years. Possible causes for this decline include the quality of lodging facilities and changes in vacation preferences. Many persons in the tourism industry believe that the quality of the lodging facilities is a major factor. However, it is difficult to measure how much each of these factors has influenced vacation travel in Minnesota.

Determining the validity of these arguments for tourism loans is beyond the scope of this report. Nevertheless, we have several concerns about tourism loan programs that we believe should be considered. The need for publicly subsidized tourism loans depends on:

- Whether many previous tourists are staying away from Minnesota because they were dissatisfied with the quality of their lodging facilities.

- Whether many additional tourists would come to Minnesota if more higher quality tourism facilities were available.

- The extent to which publicly subsidized loans displace private investment in lodging facilities.

There is little evidence that recent tourists to Minnesota were dissatisfied with their lodging facilities. For example:

- The Minnesota Office of Tourism conducted a follow-up survey of persons who requested brochures during its 1984 spring-summer advertising campaign. It found that among persons who stayed at Minnesota resorts, 49 percent rated their accommodations very satisfactory, 48 percent rated them satisfactory, and 3 percent rated them unsatisfactory. Similar ratings were obtained for campground and motel/hotel accommodations. In each accommodation category, only two percent rated their accommodations unsatisfactory.

- A study of tourists who vacationed on the North Shore of Lake Superior in 1981 found that three percent were dissatisfied with lodging accommodations and 47 percent were satisfied. Four percent were dissatisfied with campground accommodations and 34 percent were satisfied. The percentages do not add to 100 because not all tourists surveyed used lodging or campground facilities.[12]

Interpreting these results is difficult because the questions did not ask whether the vacationers would be more likely to return to Minnesota if the lodging facilities had been higher in quality.

Thus, there is little empirical evidence on whether many additional tourists could be attracted to Minnesota if more high quality facilities were available. Furthermore, there is little empirical evidence on the extent to which publicly subsidized loans displace private investment in tourism facilities. However, there are reasons to be concerned about this displacement effect:

- Due to demand for more high quality tourism facilities, many resort owners have already renovated and expanded their facilities and developers have built new facilities without public subsidy. Subsidized loan programs can increase how fast resorts expand but much of the gain may be temporary. Accelerated expansion may reduce the gap between supply and demand and consequently may diminish the incentive for future private investment in tourism facilities.

- Loan programs may subsidize projects that would have proceeded without the subsidy and thus may not have any effect on tourism development. The low interest loans proposed by DEED would probably attract some applicants whose projects would have occurred without public subsidy.

Finally, before determining whether to fund a loan program, it is important to consider alternative ways of achieving the same objective. Education and technical information services may be a less expensive way to expand tourism facilities. Many resort owners lack experience in management and may not recognize opportunities to expand or upgrade their facilities. Currently, the University of Minnesota's Agricultural Extension Service has only one person providing education and information services to tourism businesses across the state.

NOTES

[1]Proposed Biennial Budget: 1983-85, State of Minnesota, p. 6-6383.

[2]United States Travel Data Center, "The Economic Impact of Travel on Minnesota Counties: 1983," study prepared for the Minnesota Office of Tourism, November 1984.

[3]Minnesota data came from the Minnesota Department of Revenue, National data came from the United States Travel Data Center, "Travel Printout," Washington, D.C., March 1984 and June 1984.

[4]Woodside, Arch and Ilkka Ronkainen, "How Serious is Nonresponse Bias in Advertising Conversion Research?," Journal of Travel Research, Spring 1984, pp. 34-37; and Hunt, John and Michael Dalton, "Comparing Mail and Telephone for Conducting Coupon Conversion Studies," Journal of Travel Research, Winter 1983, pp. 16-18.

[5]Ballman, Gary, Jim Burke, Uel Blank and Dick Korte, "Toward Higher Quality Conversion Studies: Refining the Numbers Game," Journal of Travel Research, Spring 1984, pp. 28-33.

[6]Tourism expenditures were calculated by multiplying the following factors together:

1) the number of inquiries,
2) the percentage of those surveyed who vacationed in Minnesota,
3) the percentage of those surveyed who said that the brochure helped them decide to vacation in Minnesota, and
4) the average amount those surveyed said they spent during their vacation in Minnesota.

After each advertising season, the tourism office surveys a sample of persons who telephone or write to the office and request tourism brochures. The tourism office surveyed neither walk-in visitors nor persons who called the office but did not request brochures. Consequently, we applied the survey results for Minnesota residents to these two categories. The reported results include a high and a low estimate because of two factors:

1) Since the survey data for the 1984 spring-summer advertising season was not available when we prepared this report, we estimated expenditures for the spring and summer of 1984 on the basis of the number of inquiries during 1984 and the previous year's survey data. The high estimate assumes that the 1984 expenditures per inquiry increased by ten percent over the 1983 level. The low estimate assumes that there was no change.

Note 6, continued

2) We made both high and low estimates of non-response bias based on results from the 1983 spring-summer follow-up survey--the only survey which reported separate data for both the first and second mailings. The high estimate assumes that non-respondents were as likely to vacation in Minnesota as respondents to the second mailing. The low estimate assumes that the percentage of respondents to the second mailing who vacationed in Minnesota is proportionally midway between the percentages for first mailing respondents and non-respondents.

It should be noted that inquiries are calculated for the year ending July 31 whereas the tourism office's budget expenditures are for the fiscal year ending June 30. This is reasonable because most of the spring-summer advertising is completed well before June 30 and fall advertising does not begin until August. As a result, inquiries made in July can reasonably be attributed to advertising in the previous fiscal year.

[7]This last result is not significant at the conventional 95 percent confidence level. It is statistically significant at an 88 percent confidence level.

[8]The results for the 1983 Chicago sample of 200 active vacationing households were that about eight percent had vacationed in Minnesota during the past year. The margin of error from this estimate is about 3 or 4 percent at the 95 percent confidence level. Since the Chicago market is so large, a change of two percent would be a significant impact, yet be within the survey's margin of error.

[9]The 1984 newspaper ads may have been less effective than the 1983 ads because the 1983 ads were in color while the 1984 ads were in black and white. Also, the 1984 ads were placed in a different section of the newspaper.

[10]The loss of newspaper inquiries between 1983 and 1984 amounted to 59 percent of 1983 spring-summer inquiries for Indiana and 56 percent for Wisconsin. The corresponding loss for Illinois amounted to about 47 percent of its 1983 spring-summer inquiries.

[11]Ballman, Burke, Blank, and Korte, pp. 28-33.

[12]Knopp, Timothy and Uel Blank, "The North Shore Experience," Research Report No. 8, Minnesota Sea Grant Institute, 1983, St. Paul, MN, p. 38.

Technology Offices

Chapter 7

The Legislature established the Governor's Office of Science and Technology in 1983, with $300,000 in funding. Its role is broad--to promote the health and continued growth of high technology industries in Minnesota.

Two related offices were formed in 1984. These are the Minnesota Office of Biomedical/Health Systems and the Office of Software Technology Development. The two new offices can be viewed as efforts to break the broad mission of the Governor's Office of Science and Technology into manageable sections. The Minnesota Office of Biomedical/Health Systems promotes and assists the state's medical and health care industries. The Office of Software Technology Development encourages development of the computer software and courseware industry in Minnesota. Courseware is software used for education or training.

This chapter describes the operations of these offices, and discusses the product development loan programs proposed by the Governor's Office of Science and Technology and the Office of Software Technology Development. We raise a number of questions about the need for these programs and the way they will be implemented.

In DEED's budget these offices requested a total of $12 million to fund these programs. The money would be added to the Economic Development Fund, then product development loans would be made through this fund. The Governor's budget included no funding for these loan programs. Consistent with the Governor's recommendation, these offices now intend to make a limited group of loans, in competition with other programs for existing Economic Development Fund monies.

A. THE GOVERNOR'S OFFICE OF SCIENCE AND TECHNOLOGY

The mission of the Governor's Office of Science and Technology is:

- to make policy recommendations which support technological innovation, high technology development, and new business growth;

- to build closer ties among state government, education, and science and technology industries; and

- to expand the educational, scientific, and technological resources of the state.

The basic goal is to improve information flows among the public, private, and education sectors. The office maintains close ties with Minnesota universities and various education and technology groups. It seeks to ensure that higher education programs support the evolving labor force needs of high tech industries, and it encourages funding for product development and university research. According to staff members the office has helped the University of Minnesota obtain private and federal funds for research equipment. It also has helped public schools obtain over $500,000 in computer equipment from IBM.

The office has also developed a computerized database of information on some 1,700 high tech firms in Minnesota. The data supports office missions and can provide valuable information for planning. It can be used for projecting future labor force needs for these industries which should be valuable for career planning, university curriculum planning, and decision making on educational funding by the Legislature. The data can also provide information for the Financial Management Division of DEED and MEEDA to help identify competitors and sort out the likely impact of proposed loans.

In addition, the data can be useful to the Minnesota Trade Office. Information can be channeled to foreign trade delegations seeking to purchase Minnesota's high technology products. The Minnesota Trade Office is also involved in reverse investment--attracting foreign firms to build or produce in Minnesota. The database may be useful for assessing the desirability of attracting a high tech firm by permitting study of the impact on domestic firms.

B. THE MINNESOTA OFFICE OF BIOMEDICAL/HEALTH SYSTEMS

The Minnesota Office of Biomedical/Health Systems was established in DEED on July 1, 1984. Funding is $150,000 for the current fiscal year.

This office shares the mission of the Governor's Office of Science and Technology, except that it concentrates in the area of medical products and health care. The office:

- promotes Minnesota's medical technology products and services;
- provides information and assistance to Minnesota companies; and
- acts as a liaison between government, education, and medical/technical sectors.

The goal of promoting medical products causes a natural relationship between this office and the Minnesota Trade Office. The Trade Office has put particular emphasis on the international marketing of medical products. Because of the strong dollar, our products are expensive overseas, making it difficult to expand sales or enter new markets. However, due to the unique nature of medical products, they continue to have high export potential.

The Minnesota Office of Biomedical/Health Systems and the Trade Office also share a common database--a directory of the state's medical/technical firms. The former needs this information for its promotion efforts and its work as a liaison group and information center. The Trade Office needs this information for its trade missions, trade shows, and trade lead program.

The Minnesota Office of Biomedical/Health Systems encourages private sector funding of medical products and firms. Meetings are arranged between academic researchers and the medical industry to provide help on applications of new technology, marketing, and financing. The office believes that publicizing the scope of the medical/technical industry and its potential for growth will encourage more venture capital involvement. Meetings are also held with venture capital groups, providing them with information about emerging medical products. While difficult to quantify, this office may have value in reducing the information costs involved in investing in Minnesota companies. It may save time in locating and investigating investment opportunities.

C. THE OFFICE OF SOFTWARE TECHNOLOGY DEVELOPMENT

The Office of Software Technology Development formally began operating on July 1, 1984, funded at $150,000 for the fiscal year. Its mission is to encourage the growth and development of the computer software industry in Minnesota. One of the goals of this office is to provide financial assistance and information to computer software companies located within the state. It plans to establish a systematic procedure for informing computer software/courseware companies of available private funding sources. It also seeks to provide financial assistance through MEEDA. When this office was funded in 1984, the Legislature also amended statutes dealing with the Economic Development Fund to permit product development loans for software companies. The office is developing investment guidelines to be followed in selecting firms for assistance.

The Office of Software Technology Development is also compiling a directory of computer software/courseware development companies and consultants located in Minnesota. Some information is coming from the Science and Technology database. Various additional sources are being used because some software firms, due to their size, are not included in the Science and Technology database. Many firms are very small and some operate out of the home.

D. PROPOSED FINANCIAL ASSISTANCE PROGRAMS

The financial assistance programs of the Governor's Office of Science and Technology and the Office of Software Technology Development are intended to finance product development. They would provide financing to get ideas from the concept stage to a tangible product. This differs significantly from other DEED business loan programs. Other programs provide financial assistance for the expansion or relocation of businesses. The firms already have products and markets, and most companies remain profitable and able to repay their obligations. In contrast, product development loans will entail high risk. It can be expected that many projects supported through these programs will fail.

The Governor's Office of Science and Technology believes there is a gap in the funding of new technologies and products. According to staff, venture capitalists are reluctant to get involved prior to development of prototype products and test marketing. Accordingly, the office is requesting authorization for this program, and DEED's budget included a $4 million request for funds. As noted, the Governor recommended no funding, but if authorization is received loans could be made from existing Economic Development Fund monies. Loans would be given to firms to finance development of specific prototype products. The state would be repaid through interest and/or royalty charges. The office believes that venture capital would then be attacted to companies with products of the greatest potential. Procedures and target groups are currently being discussed. Originally, it was planned to restrict the program to high tech industries. Since similar funding proposals have come from various sources, the program might be expanded to a broader group of industries.

The Office of Software Technology Development financial assistance program was authorized when the office was founded. No funding was provided, although loans could be made by shifting money within the Economic Development Fund. As of this writing, the office has developed proposed emergency rules. No loans have been made. However, the office is requesting approval from MEEDA for a pilot product development loan of $250,000 in order to test loan guidelines, selection criteria, and procedures.

DEED's budget included a request by the Governor's Office of Software Technology Development for $8 million for this financial assistance program. The request was not supported by the Governor. According to staff, the state has many small software developers that have trouble obtaining traditional funding because of the nature of these firms. They are small and high risk. Owners often have strong technical backgrounds but they have limited business and marketing experience. Little acceptable collateral is available. The financial assistance would provide working capital to support the labor intensive process of creating computer programs. Funds could also be used to purchase computer equipment if related to the developing and testing of the software products.

To further support the software industry, the office requested additional funds for a proposed Institute For Learning Technologies, to be located at the University of Minnesota within the Department of Education. It would provide training and low-cost consulting and labor services to help develop software products. The office also requested funds for a Division of Business Services to be located in the University of Minnesota's School of Management. It would provide legal, marketing, management, and fiscal advice to software companies. Neither proposal received the Governor's support. Most of the services to be offered by the Division of Business Services are of value to any small company, regardless of its field. It is not clear to us that a separate organization is needed to supply these services to the software industry. With the possible exception of advice on marketing software products, nearly all these services are available elsewhere. A recent study noted a large number of groups statewide providing these services, many of which are underutilized.

1. NEED FOR ECONOMIC ANALYSIS

We have several concerns about these programs. First, DEED does not have an economic development plan--a broad economic policy analysis resulting in clear goals and a clear sense of what can be accomplished with the various programs it operates. DEED should not begin additional programs until a comprehensive economic development plan is completed.

We do not intend to imply that these programs should be dropped because of the risk level. These programs make sense if the benefits to the state outweigh the risk. It is thus imperative that DEED and MEEDA carefully determine an acceptable risk level, modifying collateral requirements and target groups if necessary, and analyze expected benefits before providing any financial assistance.

b. Combining Loans and Royalties

Minnesota's proposed programs may use low interest charges combined with high royalties, and both offices want their programs to be self-supporting. To do this in light of the expected failures and the low proposed interest rate, successful projects would be subject to royalties. Similar to the Connecticut program, recent proposed rules for Minnesota's software program would require royalties on sales of products developed as a result of the state's funding, until the royalties paid to the state equal a maximum of three times the funding provided. However, in the closing conference with the department we were informed that DEED is now considering requiring a minimum royalty of three times the initial funding. The royalty charge could be as high as 25 percent of product price, while the Connecticut program generally restricts the royalty to 5 percent of product price.

We question the proposed combination of low interest charges and high royalties. Although these are high risk programs, the Office of Software Technology Development is proposing to charge an interest rate five percentage points below the rate on U. S. Treasury bills. The office argues that this program is needed because these firms cannot obtain private financing. If the issue is truly one of access to funds, perhaps an argument can be made that the state should provide access to funds. It does not follow that funds for risky projects should be provided at such low interest rates. When asked about the procedure, staff provided no economic justification. The policy was proposed to be consistent with other DEED loan programs that charge low interest rates.

Because of the potential failure rate and low interest charges, DEED must charge high royalties in order to recoup losses. This burden could cause firms to be reluctant to take part in the program. Also, permitting royalties as high as 25 percent of product price will reduce the sales of the products which the state will depend on to replenish funds for the program.

DEED should consider a system of higher interest rates, or a system combining low royalties and higher interest rates. The practicality of these approaches will depend on the target group--the nature and size of the firms eventually helped under these programs. These approaches may work well if the firms are established companies with other product lines. Repaying principal and interest represents a general obligation of the company. Revenue received from all products, not just those developed through the state's funding, can be used to pay the principal and interest on the loan. This might not work if the company being assisted has no existing products and no current source of revenue.

c. <u>In-Kind Equity Contributions</u>

The proposed rules for the software program would permit MEEDA to fund up to 50 percent of working capital costs for a project and up to 75 percent of equipment costs. The remaining portion of project costs could be covered by an equity contribution. However, this equity contribution could be in the form of in-kind contributions--the fair market value of direct labor, management services, use of facilities, and equipment.

Permitting use of in-kind contributions raises an issue which should be satisfactorily resolved before using these programs. The proposed maximum percentages of cost that MEEDA will finance have no real effect. The total cost depends on the true value of the in-kind services, which could be very hard to evaluate. The firm may be so small that no formal wages or salaries are paid. The entrepreneur may have an incentive to overstate the value of these services, or time to be spent, in order to shift more of the financing burden and the risk to the state. We think that:

- DEED should examine its decision to permit in-kind contributions. If retained, DEED should develop procedures which minimize the potential for abuse.

d. <u>Funding Computer Equipment</u>

MEEDA could finance up to 75 percent of the cost of computer equipment needed to develop and test the computer programs. We observe that in practice there is no way to restrict use of this equipment solely to the project being funded. It can be used to develop many other software products.

Funding capital equipment of general use to the firm should not be done under product specific loans, at least given present procedures. The state is forced to assume unnecessary financial risk. The state must receive the bulk of its financial return through high royalties on the sale of the specific product for which the firm sought the product development loan. If this product sells poorly or does not prove marketable, the state will suffer a loss, even though the firm could use the computer equipment the state financed to produce other products which are highly profitable.

We recommend that:

- DEED should consider funding only working capital, materials, or equipment specific to the product under development.

If this is not feasible and DEED does provide funding for equipment which can be of general use to the company, we recommend that:

- DEED should consider greater reliance on higher interest rates payable from the firm's general revenues. In other words, DEED should move away from product specific royalties and move toward loans representing general obligations of the company.

e. Impact on the Minnesota Economy

DEED should use economic analysts to determine whether these programs can provide an adequate positive impact on the Minnesota economy to warrant the risk and cost to taxpayers, or whether funds are better used in other programs. Because no decision has been made regarding industries which might be helped by the Governor's Office of Science and Technology program, we cannot comment on any potential impact of that program on the Minnesota economy.

We do have reservations concerning the impact of software assistance programs. This assistance would take two forms. Some firms would receive direct funds for product development. A larger number of firms would receive services through the proposed Institute for Learning Technologies and the Division of Business Services, both to be located at the University of Minnesota. These services would include low cost labor, consulting, training, and general managerial, financial, and marketing advice.

Minnesota's education system and strong computer hardware industry are already attracting software producers. This industry would grow in Minnesota without assistance for some of the smallest firms. Also, some analysts are predicting that hardware manufacturers will expand into software production, and within a few years the larger companies will dominate the market, leaving only small specialized niches for others. The staff of Office of Software Technology Development claims that smaller companies will continue to play a role. They envision an increasing number of co-ventures between large and small companies, big companies contracting with small companies to develop specialized products, and big companies buying the products of smaller companies.

Within this environment, we wonder whether these forms of financial assistance can have a noticeable impact on employment or industry growth. In a telephone discussion with management of Connecticut's CPDC program, we were told that although they funded three software projects, they were unlikely to bring any additional software projects before their board. Two reasons were cited--extreme risk and low job creation. We feel that the most likely effect of the Minnesota assistance programs would be to change the mix of jobs, with more being retained in small firms rather than large ones. The large firms will always find it cheaper to contract for some work rather than develop the material in-house. Assisting smaller firms by direct funds, or by subsidized consulting and labor services will provide more cases where the small firm will have a cost advantage. More contracting, purchasing, and co-ventures will occur, but the total number of jobs may not be significantly changed.

An unintended consequence of the assistance may be an indirect subsidy to the larger firms. Because of the assistance to small companies, their cost of producing new products will be lower than otherwise possible. This might enable larger companies to purchase these products from the small companies for a lower price. It would certainly lower the cost of producing a product through a co-venture.

E. CONCLUSION

DEED should use its Policy Analysis Division to examine the need for these product development programs. If the programs can be justified, no loans should be made until the various problems concerning interest and royalty charges and administration of these programs are resolved. Furthermore, we recommend that:

- No additional appropriation should be made for these programs.

Since the Governor's budget did not include funds for these programs, if loans are made DEED plans to use existing Economic Development Fund revenues, in competition with other programs. Funding would begin gradually to permit unforeseen problems to surface and be resolved prior to any significant funding commitment.

Assistance Programs

Chapter 8

A variety of Minnesota organizations, such as chambers of commerce, community colleges, and local and regional development corporations, provide non-financial business assistance. Available services include management consulting, business education, and loan packaging.

The Department of Energy and Economic Development (DEED) also administers several programs that provide information and other forms of non-financial assistance to Minnesota businesses and local development agencies. This chapter describes the services available through DEED's Program of Business Information and its Development Resources Office and evaluates the recommendations for non-financial business assistance made by the Governor's Council on Small Business and Innovation. In addition, this chapter reviews DEED's efforts to assist local development agencies in developing successful economic development strategies.

A. BUSINESS ASSISTANCE PROGRAMS

1. DESCRIPTION OF CURRENT PROGRAMS

DEED's Program of Business Information serves as a clearinghouse and referral service for information needed by businesses. The program has two statutory functions: providing Minnesota's small businesses with informational services and helping Minnesota businesses secure licenses. In FY 1984, the program handled over 12,000 requests for information, assistance, or referrals.

The program implements its informational function through the Small Business Assistance Office (SBAO). This office provides a centralized location for business owners to obtain information on business issues. Although statutorily the program is available only to owners of small businesses, program staff respond to all inquiries. The majority of informational requests concern business start-up, regulation, taxation, and employer issues. When the request requires assistance beyond that available in DEED, the SBAO refers the inquiry to other organizations providing business assistance or other state agencies.

The SBAO is also required to collect and store information relating to business concerns and to publish brochures which address frequently asked questions. These materials can be sent free of charge to inquiring businesses to provide more detailed information than that available over the telephone. In addition, these materials are distributed through a variety of other public and private organizations. Two examples of the BSBA's publications are:

- *A Guide to Starting a Business in Minnesota.* This booklet outlines the major issues involved with business start-up, including incorporation procedures, licenses and permits, insurance, and taxes.

- *Small Business Assistance Directory.* This is a guide to business assistance providers in Minnesota. The directory lists the services of over 100 organizations offering business assistance.

Finally, the SBAO is required by law to certify businesses for small business tax credits, publicize the state's set-aside program and provide technical assistance to those unable to complete their set-aside contract, and promote small business participation in agency rule-making.

The Program of Business Information performs its licensing function through the Bureau of Business Licensing (BBL), which serves as a clearinghouse for Minnesota business licensing information. Although the actual review and approval of applications is performed by each state agency issuing a license, the BBL provides information and technical assistance about application processes. For example, a business owner can obtain a publication listing all licenses needed for business operation in Minnesota, the necessary application forms, and technical assistance for completing the applications. This central location for business licensing information saves time for the business owner since there is no need to contact each of the various state agencies administering the licenses.

The BBL also coordinates preapplication, master application, and environmental permit procedures.

- Preapplication conferences allow license applicants to receive a preliminary review of their project by state licensing agencies.

- Master applications expedite the identification and processing of business license applications. This process is useful for businesses requiring many separate licenses.

- Preapplication and master application procedures are also available for environmental permits. The Legislature gave this authority to the BBL in 1983.

The bureau may also request a consolidated hearing for review and approval of these special applications, thus keeping the responsibilities of the applicant to a minimum. Again, the BBL plays no role in the actual review and approval of the applications since that function is performed by the appropriate state agency.

DEED's Development Resources Office prepares community profiles which help businesses obtain information on various Minnesota cities when assessing the potential for relocation or expansion. Cities themselves, particularly small cities, often do not have the needed information readily available to respond to such inquiries. DEED staff compile and publish data characterizing approximately 200 Minnesota cities in individual community brochures. These documents are not only used by DEED for responding to inquiries, but are also provided to the cities for their promotional use. Program staff estimate that these brochures are the sole marketing tool for 50 to 60 percent of the cities for which brochures are published.

The information contained in these brochures is that which DEED believes is essential to business location decisions, such as:

- population and labor force characteristics,
- major industries,
- availability of transport services,
- tax and utility rates,
- type of city government and community services,
- proximity to educational centers, and
- availability of industrial sites.

DEED staff believe that simplifying the location search may leave the business owner with a more favorable impression of Minnesota, improving the likelihood that the project will be undertaken in the state.

The Development Resources Office can also supply business owners with information about available buildings. The office maintains a computerized data base of vacant buildings in the state available for industrial uses. Staff can match information on a company's site requirements (for example, square footage needs and price range) to the characteristics of available buildings. As a result, staff can provide a list of available buildings within the state meeting a company's requirements.

This service is often used in conjunction with community profile information. A profile of each community containing a suitable building site can be forwarded to the inquiring business. Later, if the business narrows its site choice to a specific area in Minnesota, the inquiry is referred to the appropriate business finance specialist in DEED's Economic Development Division. This person can provide the business more specialized assistance.

In summary, DEED's assistance programs serve businesses in a variety of ways. For entrepreneurs considering starting a business, DEED provides information. For businesses having management difficulties, DEED refers them to one of the many other assistance offices located in Minnesota. For businesses considering locating in Minnesota, DEED supplies information on Minnesota cities and specific industrial sites.

2. ANALYSIS OF BUSINESS ASSISTANCE PROGRAMS

In February 1984, a Council on Small Business and Innovation was convened to study ways in which the state can encourage development through community efforts. A major portion of the council's efforts focused on support services for businesses. The council reported that Minnesota has sufficient support services for small businesses and entrepreneurs, but that the services are underutilized. The final report recommended that the state adopt three major initiatives to connect the people needing services to the providers of services:

- Establish and fund a comprehensive data base on support services already available to entrepreneurs and small businesses throughout the state at a cost of $10,000 during FY 1986.

- Establish and fund a computer accessible business information system. The Minneapolis Public Library offers a computer program called "Inform" which contains exercises on developing a business plan, conducting market research and cash flow analysis, and other management issues. The council recommended that this program be expanded to include information on the business assistance services available in the state and be made available in libraries throughout the state. The Council requested $275,000 for the 1986-87 biennium to fund a pilot program in one library outside the Twin Cities metropolitan area.

- Help to fund a three-tier network of management assistance programs throughout the state at a cost of $2,570,000 during the next biennium. The network would consist of six regional cooperation offices, nine community cooperation offices serving communities with populations under 1,000, and entrepreneurial field agents.

A total of $2,855,000 was requested to implement these recommendations during the 1986-1987 biennium.

In our view, information on support services available to entrepreneurs and small businesses is already available through DEED's Program of Business Information. The *Small Business Assistance Directory* is distributed to all Chambers of Commerce, Minnesota libraries, and to any person requesting it. The availability of this information indicates that the council's recommendation for a business assistance data base would duplicate the existing state effort.

Regarding the second recommendation, there is no indication that expansion of the computer program "Inform" will result in better delivery of services. The council's report provided no data on how frequently this program is used in the Minneapolis library. In addition, management assistance is available from a number of business assistance agencies throughout the state. Expansion of "Inform" to include listings of business assistance agencies would duplicate the services provided by DEED's Program of Business Information.

Establishing an additional three-tier network of management assistance offices would also duplicate rather than make more efficient use of existing business assistance services. Data indicating the need for this extensive program was not provided in the council's report and no estimate was made of the amount of economic activity such a program would generate. In our opinion, this recommendation conflicts with the task force's premise that sufficient assistance services are available in Minnesota but underutilized.

We recommend that:

- The Legislature should not expand business assistance programs at this time. The need for additional business assistance should be carefully documented before any new programs are funded. Staff from DEED and other providers of business assistance should be consulted prior to acting on business assistance proposals to ensure that existing efforts are not duplicated.

B. LOCAL DEVELOPMENT AGENCY ASSISTANCE PROGRAMS

1. DESCRIPTION OF PROGRAMS

The Development Resources Office administers two programs which directly serve local development agencies: the Star City program and National Development Council Training programs. The Star City program prepares the staffs of local governments to take an active role in economic development planning and implemention. DEED staff assist participating cities complete the eleven program requirements, which include:

- Establishing an organization responsible for the community's economic development (a local unit of government must designate this responsibility by statute),
- Creating a local development corporation,
- Assessing the community in a profile,
- Drafting a five-year plan and strategy for economic development,
- Completing a one-year work program and defining strategy relating to the five-year economic plan,
- Producing a slide presentation of the community,
- Surveying the labor force in the community,
- Publishing a marketing fact brochure for potential developers and industry,
- Developing an annual survey of community industries to determine their expansion and relocation plans and their legislative concerns, and
- Successfully marketing the city to an industrial client.

Although the participants receive assistance from DEED, priorities and local goals must be set by each city. This ensures that economic development efforts are tailored to each city's needs.

Twenty-five Minnesota cities have completed the program as of January 1985. Most of the cities are small in size, with populations ranging from 2,000 to 10,000. Star City representatives are encouraged to provide feedback to DEED on business needs and concerns in their communities. This information can be useful to DEED in developing economic development programs and policies.

The National Development Council (NDC) contracts with DEED to provide training on economic development finance. The training program takes place in four one-week sessions. Most of the participants are staff of local development agencies. These staff often lack training in negotiating with developers for financial incentives.

The Star City and National Development Council programs do not exhaust the services DEED offers local agencies. The Economic Development Division has eight business finance specialists, each assigned to a specific area of the state to assist local businesses and to promote the state's economic development programs. The business finance specialists often work with the staffs of local development agencies and assist them with their projects. Staff of other DEED programs, such as the enterprise zone and community development corporation grant programs, provide technical assistance to local staffs. Community profiles prepared by DEED staff benefit local communities as well as businesses.

2. ANALYSIS OF LOCAL DEVELOPMENT AGENCY ASSISTANCE PROGRAMS

DEED's programs that assist local development agencies are good expenditures of state resources. It would be difficult for DEED to attempt to stimulate economic development in the state without the active and skilled involvement of local officials. We support these programs. However, we note that local officials are more likely to use public subsidies to assist businesses that are "followers" and not "leaders" in the state's economy. For example, in a local economy, a retail business can have a positive impact by adding to the tax base and by providing jobs for local residents. This business can have a detrimental impact on competing retail businesses elsewhere in the area. While it may be in a city's interest to provide subsidies to a retail business, it may not be in the state's best interests.

We believe that, through its Star Cities program, DEED should attempt to focus the efforts of local officials on attracting "leaders" that will stimulate the state's economy. Also, DEED should attempt to strengthen the capabilities of local staff in negotiating with prospective developers. Although DEED staff cover these issues in their programs, we believe greater attention to them may help maximize the economic stimulus the state can obtain from existing programs that offer public subsidies to businesses.

Marketing
Chapter 9

A. INTRODUCTION

In October 1983 the Commissioner of Energy and Economic Development appointed a task force to develop a plan and proposed budget for marketing the merits of Minnesota to the business community here and outside the state. In March 1984 the task force issued a report calling for a $1,550,000 marketing program. The Governor and Commissioner requested an appropriation of $1,300,000 from the 1984 Legislature to begin the program. The Legislature appropriated $1,100,000 to the Department of Energy and Economic Development for FY 1985 for the creation of a program of economic development marketing. Availability of a portion ($200,000) of the appropriation was made contingent on the receipt of an equivalent amount of private funds or in-kind contributions.

The primary purpose of the economic development marketing program is to persuade businesses to expand or locate in Minnesota. In addition, the program is used by the Department of Energy and Economic Development to improve businesses' awareness of the various economic development programs available from the Department of Energy and Economic Development and other state and local sources within Minnesota. The program is directed at two types of businesses: (1) Minnesota businesses considering relocation or expansion outside the state and (2) non-Minnesota businesses considering relocation or expansion. The goals of the program, as stated in the task force's report, are:

- to convince existing Minnesota businesses to remain in Minnesota,
- to encourage existing Minnesota businesses to expand in Minnesota,
- to encourage non-Minnesota businesses to either locate expanding operations in Minnesota or relocate existing operations to Minnesota, and

- to persuade new business start-ups to locate in Minnesota.

The program is operated by the department's Marketing Office, which is part of the Economic Development Division. The office has a staff of six responsible for managing the program, responding to inquiries generated by advertising campaigns, referring inquiries to other divisions of the department when appropriate, developing brochures and fact sheets for distribution to those inquiring about an advertisement, preparing articles for publication in Minnesota newspapers or in a business newsletter (Minnesota Magazine) which is circulated by the department, conducting a telemarketing campaign, and performing a number of other public relations tasks.

The public relations and advertising work is provided by consultants hired by the Marketing Office. A Twin Cities firm has a $945,000 contract with the state to provide public relations work, design advertisements, and purchase advertisement space in newspapers and magazines for this year's advertising campaign. The local public relations firm has subcontracted the actual design of advertisements to a Twin Cities advertising agency. Although much of the actual marketing work is contracted to private firms, Marketing Office and department management are actively involved in decisions on advertisement design and placement.

The Marketing Office also has hired a consultant to conduct a survey of the attitudes of approximately 200 executives of Minnesota-based manufacturing companies about the environment for doing business in Minnesota and the various economic development programs offered by the state. The office plans to conduct surveys in future years to determine the extent of change in business attitudes and the impact of the marketing program and other factors on perceptions of Minnesota.

During FY 1985 the program's resources have been used primarily within Minnesota. Advertisements have appeared or will appear in three types of publications within Minnesota:

- general circulation newspapers throughout the state;
- business related publications, including Minnesota business magazines and the regional edition of the *Wall Street Journal*; and
- Minnesota editions of general circulation magazines.

Newspaper advertisements began appearing in November 1984 and are scheduled to appear through June 1985. The newspaper campaign consists of four differently designed advertisements that will be used alternately throughout the promotion. The advertisements were placed twice during November 1984 in each of 26

Minnesota newspapers. In nine newspapers, including most of the largest ones, the advertisements are scheduled to appear six additional times, once monthly through June 1985. Advertisements in the other 17 newspapers are scheduled to appear four additional times through June 1985. The combined circulation of the selected newspapers totals 1,217,674. Costs for placing the advertisements are estimated to be approximately $156,100. Table 9.1 provides a summary of the costs and placements for the newspaper advertisement campaign. Figure 9.1 is an example of one of the advertisements used in this campaign.

The newspaper advertisements were first scheduled to appear in September 1984. Objections were raised that their content could be considered politically motivated if they appeared during an election campaign. Subsequently, the Commissioner of Energy and Economic Development delayed the placement of newspaper advertisements until after Election Day in November 1984.

The other part of this year's instate advertising efforts consisted of placing the same advertisements in Minnesota business magazines, the regional edition of the *Wall Street Journal*, and the Minnesota editions of national general circulation magazines. Advertisements in Minnesota business magazines were first placed in September 1984 and are scheduled to appear through March 1985. Advertisements in the regional edition of the *Wall Street Journal* appeared in November and December of 1984 and January 1985. Between January and April of 1985, advertisements will be placed four times in the Minnesota editions of both *Time* and *Newsweek* magazines. Table 9.2 summarizes the Minnesota business magazine campaign.

In January the Marketing Office also began a telemarketing campaign within Minnesota. The office sent letters to the chief executive officers of over 300 biomedical companies in Minnesota and has been following up those letters with phone calls. The purpose of the telemarketing campaign is similar to the various advertising campaigns but will be more effectively targeted to those individuals the program is intended to reach. The office plans to conduct similar telemarketing efforts with other types of firms in the future.

In April 1985 the Marketing Office plans to begin an advertising campaign outside Minnesota. A twenty-two page section on Minnesota will appear in the Top Management Edition of *Time* magazine. This section will consist of a one page advertisement prepared by the office's consultants, ten pages of advertisements purchased by Minnesota companies, and eleven pages of editorial material prepared by the staff of *Time* magazine. The one page advertisement will cost the state approximately $36,000. The ten pages purchased by Minnesota companies will more than fulfill the statutory requirement for private matching funds.

TABLE 9.1

MARKET MINNESOTA INSTATE NEWSPAPER CAMPAIGN

Newspaper	Circulation	Number of Placements	Estimated Costs
Minneapolis Tribune	578,842	9	$ 61,863
St. Paul Pioneer Press	215,958	9	27,706
Duluth News Tribune Herald	82,148	9	11,917
Albert Lea Tribune	10,256	9	2,856
Austin Herald	9,835	9	2,856
Brainerd Dispatch	15,636	9	2,933
Fargo Forum (MN edition)	18,555	9	4,658
Winona News,	17,022	9	4,505
Rochester Post	40,004	9	6,222
Marshall Independent	8,793	6	1,300
New Ulm Journal	10,735	6	1,530
Worthington Globe	15,869	6	1,673
Hibbing Tribune	1,693	6	1,066
Virginia Mesabi Daily	15,086	6	1,484
Mankato Free Press/ Owatonna People's Press	34,634	6	4,004
Willmar West Central Tribune	16,276	6	2,428
Bemidji Pioneer	7,329	6	1,571
Crookston Times	4,918	6	1,530
Faribault News	8,726	6	1,346
Fergus Falls Journal	13,416	6	1,484
International Falls Journal	5,113	6	1,214
Red Wing Republican Eagle	8,827	6	1,020
St. Cloud Times	28,395	6	4,723
Stillwater Gazette	5,325	6	1,346
Wahpeton/Breckenridge News	6,650	6	1,260
Fairmont Sentinel	11,633	6	1,616
Total	1,217,674	123	$156,105

Source: DEED.

FIGURE 9.1

SAMPLE ADVERTISEMENTS

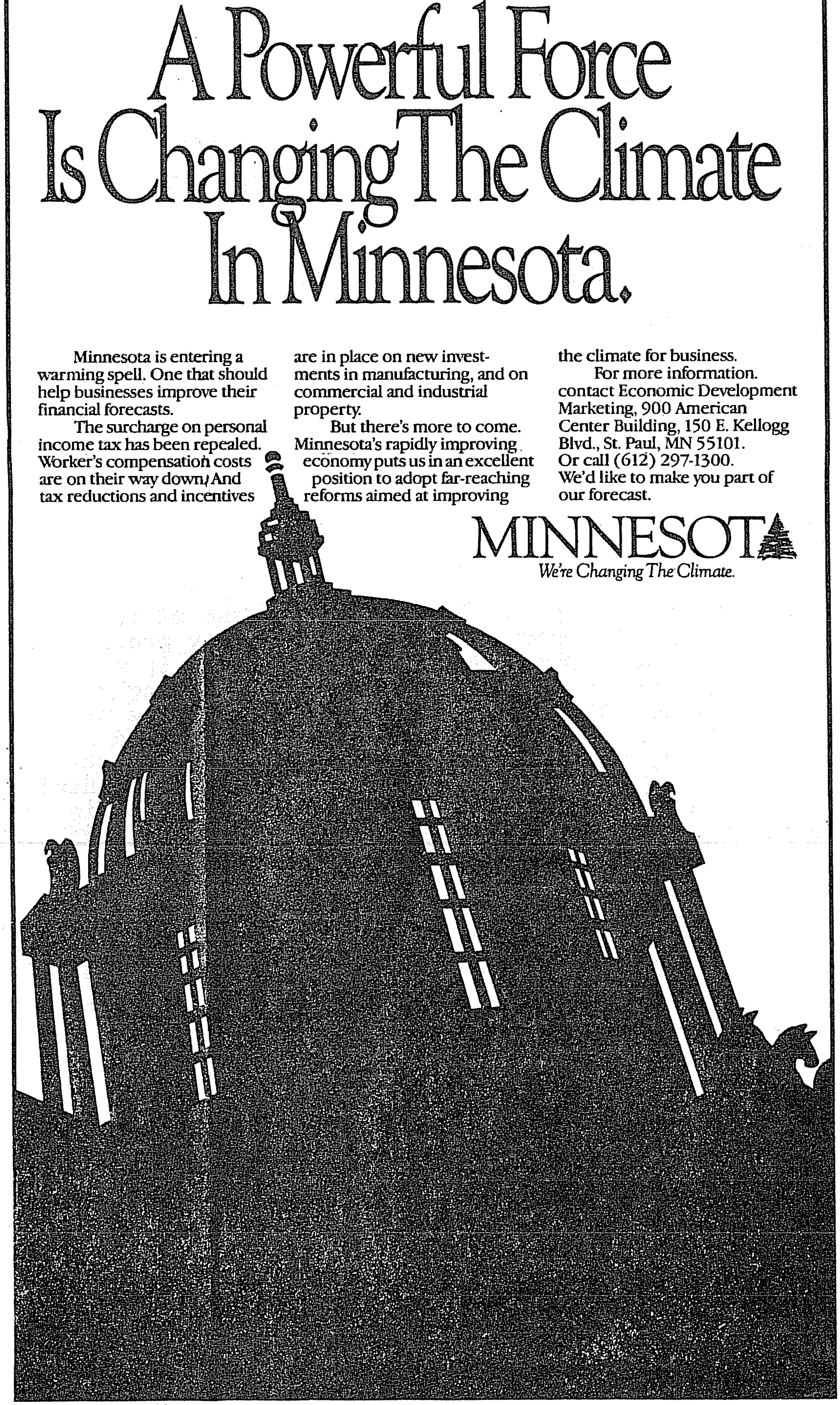


TABLE 9.2

MARKET MINNESOTA BUSINESS PUBLICATION CAMPAIGN

Journal	Number of Placements	Estimated Costs
Wall Street Journal (Regional Edition)	3	$ 28,538.17
Corporate Report	5	13,211.98
Minnesota Business Journal	4	8,797.50
Business Views	4	7,180.80
Time (Minnesota Edition)	4	28,225.30
Newsweek (Minnesota Edition)	4	20,172.63
Total	24	$106,126.38

Source: DEED.

According to the director of the Marketing Office, further plans for the campaign outside Minnesota are only preliminary at this time. However, the director indicates that in the coming biennium the program will spend more on advertising outside Minnesota than on advertising within Minnesota. The marketing effort within Minnesota will continue, but at a reduced level, and will instead rely primarily on the telemarketing efforts. A specific breakdown of how marketing expenditures would be divided between the Minnesota campaign and the national campaign is not yet available from the Marketing Office. A list of publications in which advertisements would be placed within and outside of the state also has not yet been prepared.

The Department of Energy and Economic Development had requested an additional $200,000 for FY 1986 and $300,000 for FY 1987 to expand marketing efforts outside Minnesota. However, the Governor recommended that funding for the marketing program continue at the same level.

B. PROGRAM ANALYSIS

The newness of the economic development marketing program limits the degree to which this study can examine the effectiveness of the program. The program first began advertising only six months ago and began major newspaper advertising only four months ago. The telemarketing effort began only two months ago. Plans for next biennium's marketing efforts are still at a formative stage at this time. Nonetheless, there are a number of important questions that we believe should be raised about the potential effectiveness of this program as an economic development tool. In particular:

- What audience should the marketing program attempt to reach?
- Is the message being delivered in the most cost-effective way?
- Does the department intend to measure the effectiveness of the marketing program in stimulating economic growth?
- Can an advertising and public relations campaign have any significant impact on economic development?

We discuss these issues below. We examine the targeting of the marketing program and discuss the potential impact of such a program on a state's economic growth.

1. TARGETING

Important factors in the success of any advertising campaign are identification of the proper target population and structuring the campaign to reach that population in a cost-effective way. The more clearly the target group is defined and the more carefully the campaign is directed at that group, the more likely the campaign will be successful. This is particularly true for campaigns designed to create favorable attitudes, such as the economic development marketing program.

According to the director of the Marketing Office, the primary audience of the state's advertising campaigns consists of the chief executive officers and top management of existing Minnesota businesses. The secondary target audience consists of chief executive officers and top management of non-Minnesota businesses, particularly those in high technology, light industry, services, and international trade.

We agree that the program should target these two groups. However, the use of newspaper advertisements within Minnesota is not necessarily consistent with the decision to target these groups. Newspaper ads reach a much larger audience, including only a few individuals who could potentially be influenced to make a decision that would result in the location or expansion of a business in Minnesota. Similarly, the advertisements in Minnesota editions of *Time* and *Newsweek* reached a much larger audience than necessary for the purposes of the marketing program. Advertisements in Minnesota business magazines and the regional edition of the *Wall Street Journal*, as DEED has placed through their publication campaign, are more likely to reach the targeted group within Minnesota at a lower cost. Direct mailings to Minnesota business executives, such as DEED's Minnesota Magazine, are even better targeted and could be more cost-effective than advertising. Newspaper advertisements may have served a purpose in initiating the marketing program. However, their continuation would not be consistent with the goal of targeting chief executive officers and top management.

The direct mailing and telemarketing campaign recently begun by the Marketing Office should be beneficial in narrowing the primary target group even further. Ultimately a successful marketing program should attempt to identify those Minnesota businesses which are considering relocation or expansion now or in the near future. Those considering a move or expansion outside Minnesota could be targeted for additional mailings and personal contacts with the department's development staff, including its business finance specialists. This would enable the department to become more proactive in attempting to keep Minnesota businesses within the state. The survey of executives of Minnesota-based manufacturing companies could also be used to identify firms on which development staff should focus their efforts.

Little is known at this time about plans to advertise outside the state. The initial ads are scheduled to appear in the Top Management Edition of *Time* magazine during April 1985. This edition is circulated to 600,000 business executives across the country. We believe this is an appropriate first step in the national advertising campaign particularly since the state is able to obtain 22 pages on Minnesota for the cost of one page. However, it would be inappropriate for the marketing program to continue to use this type of magazine extensively in future phases of the national campaign unless a similar targeting and leveraging of the state's expenditures can be achieved. Illinois' marketing program places several advertisements annually in business magazines such as *Business Week*, but concentrates its advertising efforts on publications read by business owners considering location decisions such as *Area Development* and *Plant Location* and on industrial journals like *Chemical Week*. A selective campaign is more likely to reach business executives who are looking for site locations or are in the industrial sectors chosen as a state priority.

We conclude that:

- Advertisements in newspapers and other non-business related publications are not the most cost-effective method of reaching the targeted audiences. Greater use of business and trade publications may be more cost-effective.

- Targeted mailings to business executives are preferable to mass advertising.

- Contacts with Minnesota business executives should be used to better determine why those executives who say their company may expand or move elsewhere in the near future are considering locations outside Minnesota. Also these contacts could be used to narrow the target group within Minnesota to those companies contemplating a move or expansion.

We recommend that:

- The Marketing Office and department management carefully assess whether the marketing campaign within Minnesota and the proposed nationwide campaign are being targeted appropriately.

- In reviewing the department's budget request for the next biennium, the Legislature should consider whether the department has a good advertising plan both within and outside the state.

We believe that the department needs to become more proactive if marketing efforts are to be successful. However, we would be concerned if marketing efforts were used simply to attract clients for the department's financial programs. The state should be selective in determining the types of businesses that are offered a public subsidy. In addition, it is not necessary to subsidize most economic development projects in order for them to occur within Minnesota. While the telemarketing program may identify companies contemplating expansion, not all of these projects will require state financial incentives to proceed in Minnesota. The marketing program should be directed at persuading businesses to stay in Minnesota and expand here and should not be primarily used to generate a clientele for the financial programs offered by the department and other development agencies in the state.

About six weeks ago, the department hired a new director of marketing. Within the last several weeks, the new director began to draft a marketing plan for the 1986-87 biennium. Although the draft plan is not specific about the breakdown of advertising expenditures between the Minnesota and national campaigns, it seems to reflect some of the same general types of concerns we have raised in this section. The draft plan indicates the Minnesota advertising campaign for the next biennium will undergo considerable change. Advertisements in general circulation newspapers will be greatly reduced and used only where deemed appropriate in order to fill gaps in demographic coverage. In addition, the telemarketing campaign will become an increasingly crucial component of the program's efforts in Minnesota. Outside of Minnesota, the Office of Marketing plans to advertise in some site location magazines and trade journals and will focus on the top management editions of national news magazines.

As a result, we believe that the state's marketing program is now moving in the right direction. Nonetheless, we think that the appropriate legislative committees should have the department prepare a more specific marketing plan for legislative review.

2. IMPACT ON ECONOMIC DEVELOPMENT

In the section above, it was assumed that a well designed marketing program can have some impact on economic development. With that assumption in mind, we discussed a number of ways in which the state's $1.1 million marketing budget could be better spent. However, we have some reservations about whether a marketing program can have a significant impact on a state's economic growth.

Department staff defend the marketing program because they believe that negative attitudes about a state's business climate can adversely affect a state's economy. They contend that a large number of Minnesotans have negative perceptions about the state's business climate but that these perceptions are unwarranted since improvements have been made in state policies affecting businesses. The marketing program is consequently intended to make people aware of the efforts to improve the business climate and to let them know that Minnesota cares about business. They assume that the marketing program can favorably affect the attitudes of people, particularly business executives. Also, they assume that more favorable attitudes will result in more economic growth in Minnesota because business owners will be more likely to locate or expand here. The report of the Commissioner's Economic Development Marketing Task Force argues these same points.

This argument may be flawed. First, it assumes that business executives are unaware of changes that have been made in Minnesota affecting the costs of operating their businesses. One could argue, however, that business executives within Minnesota are well aware of the advantages and disadvantages of doing business in this state. They are less likely to be accurately informed about the advantages and disadvantages of doing business elsewhere and could be misled by development agencies from other states.

Second, business location decisions are based largely on economic factors such as the market proximity, proximity to raw materials, and the availability of an adequate labor force. A one page advertisement that conveys no detailed information about such factors is unlikely to convince a business executive to change a business location decision.

Finally, it is possible that the advertising campaign could affect the attitudes of some individuals adversely. A few people have called the Marketing Office to complain about tax dollars being used for an advertising campaign.

Unfortunately, there is little evidence to either support or refute the assumptions used in the defense of a marketing program. Other states we contacted -- including Illinois, Ohio, Michigan, and Wisconsin -- do not collect the kinds of data necessary to determine whether marketing programs can affect economic growth. The data the Minnesota Marketing Office plans to collect, although an improvement over other states, may not be adequate for that purpose either. If conducted annually, the attitude survey of manufacturing executives could indicate how attitudes have changed. However, it is unlikely that the survey data will be able to tell us if improved attitudes are due to the marketing program or to other factors. Although the office also plans to monitor the number and nature of inquiries from its advertising campaigns, there are no plans to determine whether those inquiring are in a position to, or eventually do, locate or expand a business in Minnesota, particularly a type of business that would be a net producer of income for the state's economy.

Due to the lack of evidence, it is impossible to say whether a marketing program can have a positive impact on economic growth. However, as pointed out earlier in this chapter, it is important to consider whether the state's marketing program is appropriately targeted. While preliminary draft plans for next year's program indicate that the Marketing Office intends to move in the right direction, we believe it is crucial for the Legislature to review more detailed plans when considering the program's budget request. With these plans, the Legislature will be able to better assess whether the program funds will be expended in a cost-effective manner.

Conclusions

Chapter 10

The Department of Energy and Economic Development (DEED) has faced the difficult task of implementing a number of important new or greatly expanded programs in a short period of time. These economic development programs were authorized or expanded by the Legislature less than two years ago. In some instances, the programs were authorized during the 1984 legislative session, less than one year ago.

Considering the scope of this task, we believe that the department has generally done a good job in implementing these programs. The department has appropriately targeted manufacturing firms for financial assistance through Economic Recovery Fund grants and its major loan programs, the Small Business Development Loan Program and the Minnesota Fund Program. In general, it is more productive to target financial assistance to manufacturing firms than to other types of businesses.

However, simply providing financial assistance to manufacturing businesses that apply for these programs does not ensure that the programs are creating jobs. In the future, the department needs to more carefully review loan and grant applications from manufacturing firms to ensure that economic development funds are used in the most cost-effective manner. In particular:

- The department should examine the impact that a publicly subsidized business expansion might have on employment at other Minnesota businesses competing in the same product market.

This issue is not being systematically examined now because the loan review process focuses primarily on financial considerations. The department should involve economic analysts from its Policy Analysis Division in the review of proposed loans and grants.

Also:

- The department should more rigorously review applications to ensure that public funds are not used to displace private financing and that no more subsidy is provided than is necessary for a business expansion to be undertaken.

To some extent, these issues are being considered. We believe they need more thorough review and consistent application across programs. In particular:

- DEED and the Minnesota Energy and Economic Development Authority (MEEDA) should change the standard practice of providing below-market-rate financing to all firms receiving Minnesota Fund loans.

- DEED and MEEDA should not use the Small Business Development Loan Program for business projects that would be undertaken in Minnesota with private financing.

DEED should also consider whether below-market-rate financing is necessary for all businesses receiving loans financed by the Economic Recovery Fund

The department plans to implement two additional loan programs: one for small software development companies and another for small tourism businesses. In addition, the department is proposing a product development loan program to finance the development of product prototypes. We think that the software development and product development loan programs need to be reviewed more carefully by department staff outside of the technology offices, particularly the Policy Analysis Division and the Financial Management Division, before being implemented. The experience of other states that have operated similar programs should be considered in light of the riskiness of these loans. It is unclear whether the proposed tourism loan program is the best available use of monies in the Economic Development Fund. If implemented, however, we believe it should be targeted to economically distressed areas of the state and to tourism facility improvements that would not take place without state loan participation.

The department's expanded tourism promotion efforts appear to have been generally successful in stimulating the state's economy, although not as successful as program advocates suggested. Our best estimate is that the additional state expenditures on promotion and advertising are generating, on average, at least $5 in additional tourism spending per tax dollar spent. However, some of the expanded efforts have yet to generate benefits much greater than their costs. In particular:

- The 1984 television advertising campaign conducted in out-of-state markets does not appear to have been very effective. Initial data on the inquiries generated by the campaign and its impact on Minnesota's share of the out-of-state vacation market are not encouraging.

However, it is too early to conclude that television advertising outside Minnesota cannot be effective. The tourism office experienced several problems in implementing the first year of the advertising campaign and is taking steps to correct those problems during this year's campaign. In addition, it may take repeated exposure to television to change the vacation choices of non-Minnesota residents. The effectiveness of the 1985 television campaign needs to be closely monitored to ensure that future promotional expenditures are targeted to those markets and media that bring the highest return.

We also recommend that the Minnesota Office of Tourism develop a methodology for estimating the return on investment for major advertising campaigns, particularly those conducted outside Minnesota. The office has in place some of the studies and surveys needed to estimate the return that the state is receiving for its tax dollars. However, the office needs to combine survey results with a methodology similar to but more extensive than the one we used in this report. We believe it is important to know which of the various expanded tourism promotional efforts have been worth their cost.

The department needs to better target the economic development marketing program that began last year. We recommend that:

- Advertisements in general circulation newspapers in Minnesota, while they may have served a purpose in initiating the program, should not be used in subsequent years.

- The department's advertising campaign should be targeted to business executives in Minnesota and elsewhere who could potentially be persuaded to locate, expand, or retain a business in Minnesota.

- The program should become more proactive and attempt to identify firms that are: 1) considering a move out of Minnesota, 2) considering expanding outside of Minnesota, and 3) considering various sites here and elsewhere for a business start-up or expansion.

There are indications that the department has recently begun to move its marketing program in this direction. The Marketing Office began a telemarketing campaign within Minnesota in January. Among the purposes of the campaign is the identification of Minnesota businesses with specific expansion or relocation plans and any problems those businesses may have with staying or expanding in Minnesota. In addition, within the last several weeks, the new director of marketing began to draft a marketing plan for the 1986-87 biennium. Although the initial draft plan does not provide a specific breakdown of advertising expenditures, it seems to reflect most of our concerns about targeting. In particular, the draft plan indicates that advertisements in general circulation newspapers will be greatly reduced and used only where deemed appropriate in order to fill gaps in demographic coverage.

The Legislature needs to reexamine some of the programs established or expanded in the last two years. These include the various business tax credits enacted over the last two years. We recommend that:

- The Legislature should not appropriate any additional funds for competitive city enterprise zones or grant tax credits to specific companies through legislation. The Legislature should instead consider establishing an "economic opportunity zone" program so that credits can be better targeted for use in attracting significant business expansions and start-ups, particularly for communities with high unemployment rates.

- The Legislature should reassess whether the equity investment credit is the best available use of state funds for economic development purposes. If the credit is retained, eligibility should be more restricted.

- The Legislature should consider not renewing the small business assistance office credit. If it can be demonstrated that public funds for small business assistance offices are needed and would result in significant economic benefits for the state, funding should instead be provided through an appropriation to DEED for a grant program.

We also recommend that:

- The Legislature should change the Economic Recovery Fund Program so that, in the future, the entire amount loaned to a business will be repaid to the state. This change will help ensure that future uses of repaid loans are properly targeted and that more cities can benefit from the program.

- The Legislature should consider phasing out state planning grants for community development corporations. The Legislature should also consider whether venture capital grants to community development corporations have been a productive use of economic development resources after this year's grant recipients are selected by DEED. At a minimum, the Legislature should consider requiring that grants loaned to private businesses be repaid to the state so that future uses of repaid loans are properly targeted.

Finally, DEED should continue the research its Policy Analysis Division has begun on the Minnesota economy. The division's research will hopefully be useful both in designing and targeting economic development programs and in recognizing the limitations to providing financial incentives to certain sectors of the economy and types of businesses. We believe that the division's research may be helpful in guiding state policies in areas such as taxation and education as well as economic development programs.

Iron Range Resources and Rehabilitation Board
Part Two

Introduction

Chapter 11

The Iron Range Resources and Rehabilitation Board (IRRRB) is a unique state agency. It has a purely regional focus and only occasionally receives appropriations from the state's General Fund. Financing for the board's activities comes primarily from taconite production taxes levied on taconite mining companies in lieu of property taxes. The IRRRB is responsible for addressing:

- environmental problems caused by the removal of natural resources, and

- unemployment problems resulting from a decline in mining activity in northeastern Minnesota.

Under this broad charge, the IRRRB has funded various types of economic development projects since its establishment in 1941. In the 1950s, it sponsored research on forestry, taconite, and peat development. In the 1960s, the IRRRB made loans to new businesses. In the 1970s, it turned its attention to tourism-related projects, primarily development of the Iron Range Interpretative Center in Chisholm.[1]

Since 1983, however, economic development has become the IRRRB's major focus. Today, most of the IRRRB's spending is directed at improving the economy of northeastern Minnesota. Major commitments to economic development projects include the following:

- $8.5 million for expanding the Iron Range Interpretative Center in Chisholm,

- $6.9 million for developing the Giants Ridge ski area near Biwabik,

- More than $5 million in loans to Iron Range businesses and resorts,

- Approximately $4.9 million in grants and loans to Iron Range school districts and other public agencies to convert boilers to burn wood or peat,
- $5 million for a common bond reserve fund to secure industrial revenue bonds issued by the IRRRB,
- Approximately $1.4 million for development of a demonstration facility for producing steel and pig iron from taconite using plasma-smelt technology,
- $850,000 in IRRRB administered research at Wilderness Valley Farms to determine the feasibility of producing peat from a prepared peat bog,
- $750,000 to a foreign company for documenting the costs of producing peat from an unprepared bog, and
- An interest buy-down costing approximately $200,000, in addition to issuing $10 million in industrial revenue bonds, for the private development of a waferboard plant in Two Harbors.

In the near future, the board and its management will probably consider a number of other major expenditures, including:

- Construction of a $1.8 million science museum and a $2.0 million historic mining village at the Iron Range Interpretative Center,
- Development of the Giants Ridge facility into a year-round training center and tourism attraction,
- Possible subsidies to private developers for the construction of a hotel complex adjacent to the site of the interpretative center,
- Development of a wood products industrial park, and
- Loans to private companies for converting their heating systems to fiber fuels.

This dramatic increase in IRRRB funding for economic development comes in response to a severe recession in the taconite industry of northeastern Minnesota. Changes in international steel markets as well as a nationwide recession have caused mining companies, which are the major contributor to the region's economy, to shut down their operations frequently over the past several years. The unemployment rate in the seven-county region of northeastern Minnesota excluding Duluth rose to 24.9 percent in February 1983 and has most recently been estimated to be 18.2 percent.[2] Average employment in the taconite mining industry was approximately 13,600 in 1981, compared to 6,000 in 1983 and

7,100 in 1984.[3] By one estimate, the region has permanently lost as many as 10,000 jobs tied directly or indirectly to the mining industry.[4]

The severity of the economic recession on Minnesota's Iron Range has caused IRRRB to rather quickly become an economic development agency. Like other development agencies, the IRRRB is primarily concerned with creating new jobs. However, it has faced the additional task of quickly creating those jobs. In meeting this challenge, the board and its management has moved rather rapidly and committed significant resources.

In Part Two of this report, we examine whether IRRRB's investments are likely to be effective in creating jobs for the depressed Iron Range. In particular, we address the following issues:

- Does the IRRRB have a coherent economic development plan?
- Does IRRRB management adequately analyze the benefits and costs of proposed economic development projects?
- Are the IRRRB's current economic development ventures likely to create jobs and diversify the Iron Range economy?
- How can IRRRB best use its resources in the future to relieve the economic distress on the Iron Range?

Chapter 12 provides background information on the IRRRB and its funding sources. It also briefly summarizes the economic development plan prepared by the IRRRB. The next three chapters examine in detail the IRRRB's major economic development ventures in three areas: 1) manufacturing and other business development, 2) tourism development, and 3) alternative energy development. Finally, we summarize our findings and recommend changes in the IRRRB's economic development programs and in the process for determining future development projects.

NOTES

[1]Stinson, Thomas and Karen Vogl, "Iron Range Resources and Rehabilitation Board: 36 Years of Experience," Minnesota Agricultural Economist, February 1978, pp. 1-7.

[2]Minnesota Department of Economic Security, "Northeastern Minnesota Labor Market Review," April 1983 and February 1985.

[3]These figures include workers who were laid off during parts of these years. The data was compiled by the Lake Superior Industrial Bureau and reported in the Minneapolis Star and Tribune, January 30, 1985.

[4]Northeast Minnesota: A Region in Transition (Summary Report of the Northeast Minnesota Task Force), Agricultural Extension Service, University of Minnesota, December 1983, p.4.

Organization and Funding

Chapter 12

The Iron Range Resources and Rehabilitation Board consists of five state senators and five state representatives, a majority of whom must come from northeastern Minnesota, plus the commissioner of natural resources. The commissioner of the IRRRB is appointed by the Governor. Additional staff, totaling 93.5 permanent positions, implement IRRRB policy and maintain daily operations. Figure 12.1 shows the organization of the IRRRB.

The IRRRB acts on behalf of the primary taconite tax relief area of northeastern Minnesota, as shown in Figure 12.2. In addition, the IRRRB administers a special grant program for Carlton and Koochiching counties that is funded by occupation taxes on mining. These counties are considered secondary relief areas since taconite mining and production does not occur within their boundaries.

There are three primary sources from which IRRRB receives funds:

- The board's general account,
- The Taconite Area Environmental Protection Fund (TEPF), and
- The Northeast Minnesota Economic Protection Trust Fund (NEPF), also called the "2002 Fund."

These sources are funded by production taxes paid by mining companies in lieu of property taxes.[1] Table 12.1 shows the distribution of production tax receipts to the board account, the TEPF, and the NEPF in recent years.

FIGURE 12.1

ORGANIZATIONAL CHART

IRON RANGE RESOURCES AND REHABILITATION BOARD

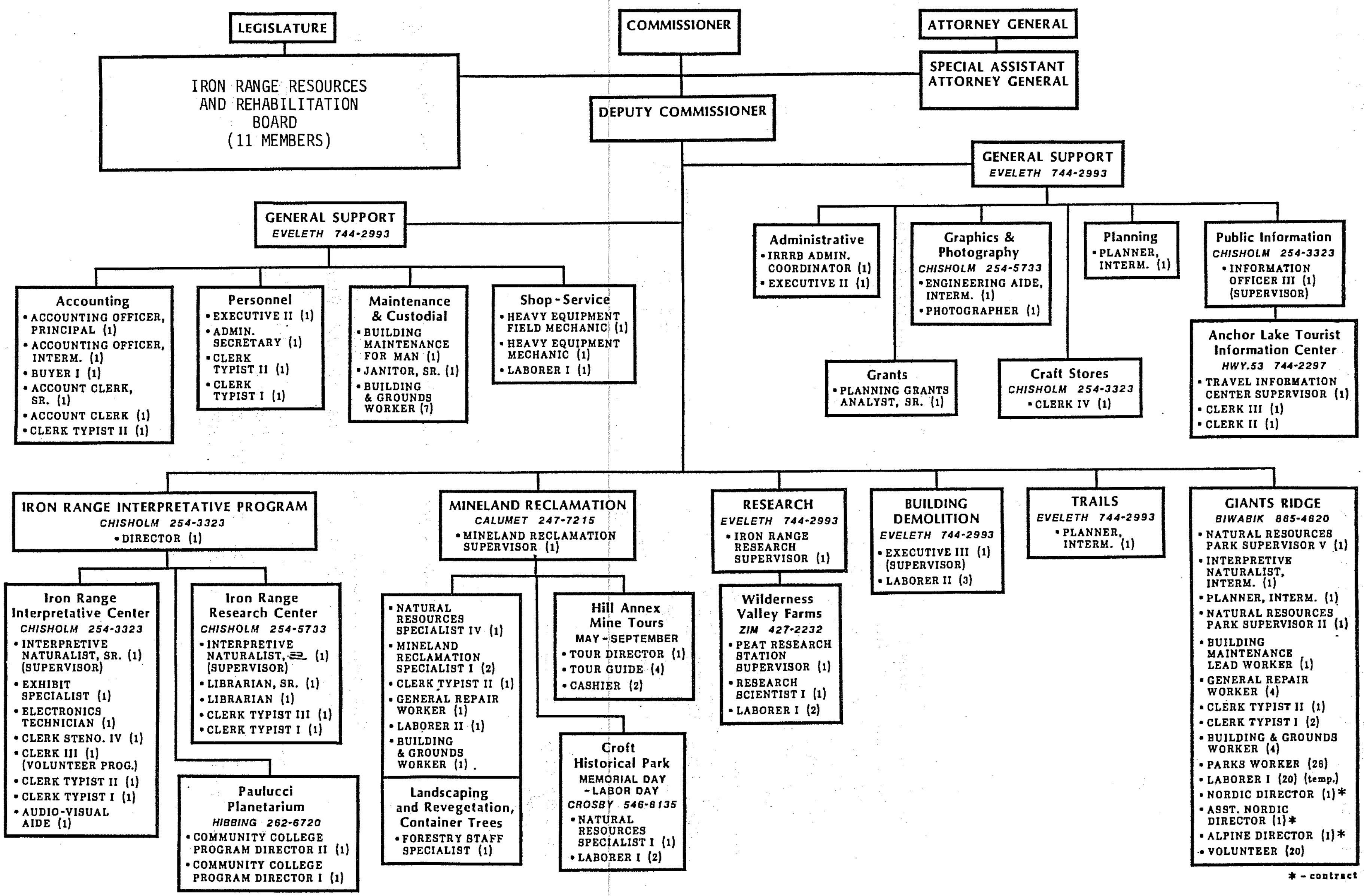


FIGURE 12.2

PRIMARY TACONITE TAX RELIEF AREA

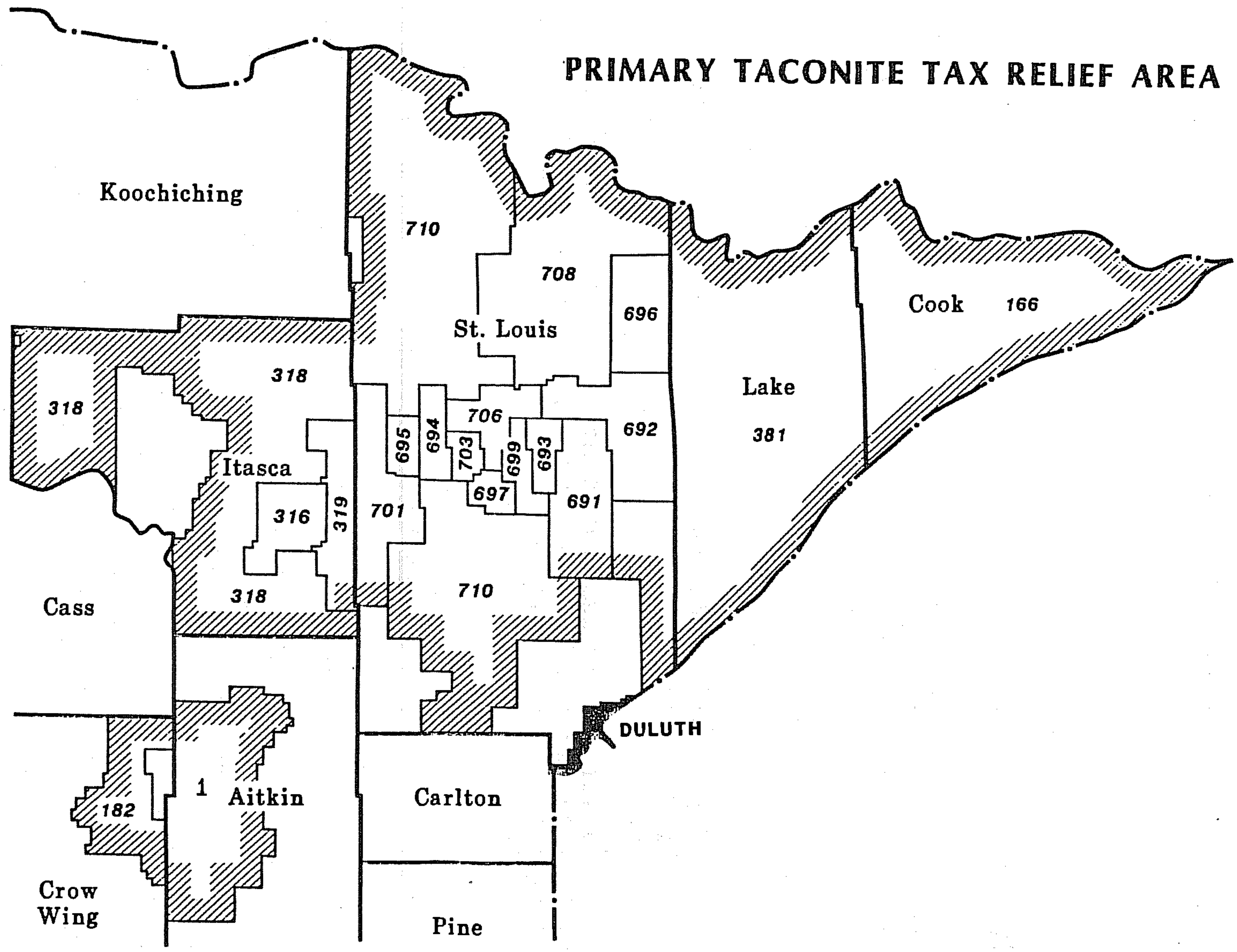


TABLE 12.1

TACONITE PRODUCTION TAX RECEIPTS

Fiscal Year of Receipt	Board Account	TEPF[1]	NEPF[1]
1978	$2,003,658	$ 6,044,915	$3,022,456
1979	2,244,799	11,385,218	5,692,609
1980	2,359,985	17,928,979	8,964,490
1981	3,254,359	15,663,492	9,358,171
1982	3,517,809	18,899,997	9,265,064
1983	3,403,242	11,405,306	2,793,123
1984	3,300,000	6,098,599	(2,076,400)[2]

Source: Minnesota Department of Revenue, 12/28/83 and 2/6/85.

[1]These figures do not include interest and earnings received by the IRRRB from these two funds. The figures for the TEPF include return of the unallocated school fund index.

[2]The NEPF was drawn down in this year to cover aid guarantees to other Iron Range organizations. Amendments to the production tax distribution formula make this unlikely to occur in the future.

A. THE BOARD ACCOUNT

The board's general account is the smallest of the three funds. This account receives a fixed annual allocation of $1,252,520 plus a variable allocation of three cents per taxable ton of taconite produced. The account also receives receipts generated by IRRRB tourism facilities and other operations. The board account can be used to relieve the "distress and unemployment (that) exists or may exist in the future . . . by reason of the removal of natural resources or a possibly limited use thereof in the future."[2] This account is primarily used to pay for the IRRRB's administrative expenditures and the costs of operating its tourism-related and other facilities. According to law, expenditures from the board account can be made by the commissioner after review by the board. Typically, however, the commissioner only expends funds with the approval of the board. Table 12.2 shows the board account receipts and expenditures during FY 1984 and the budgeted amounts for FY 1985.

TABLE 12.2

BOARD ACCOUNT:
SOURCES AND USES OF FUNDS FOR FY 1984 AND FY 1985

Sources of Funds	Actual FY 1984	Budgeted FY 1985*
Taconite Production Taxes	$3,403,242	$3,414,270
Receipts from Agency Operations and Other Sources	319,292	685,985
Total Receipts	$3,722,534	$4,100,255
Carry Forward from Previous Fiscal Year	1,353,015	748,048
Total Sources of Funds	$5,075,549	$4,848,303
Uses of Funds		
Agency Administration		
General Support	$ 480,462	$ 477,703
Shop	52,681	83,448
Professional Services	85,000	85,000
Economic Development Programs		
Summer Youth Employment	210,000	259,250
Trails Program	54,500	175,850
Building Demolition	194,783	215,644
Wilderness Valley Farms (Peat Project)	153,827	0
Jobs Program	25,000	0
Out of State Travel	**	53,200
Tourism Related Programs		
Public Relations	62,383	53,496
Public Information (Anchor Lake)	63,072	73,058
Paulucci Planetarium	17,101	207,536
Giants Ridge	400,000	750,000
Croft Mine	32,750	32,405
Iron Range Interpretative Center Complex		
Center Operations	617,525	749,025
Research Library	267,824	328,609
Buildings and Grounds	333,679	387,982
Graphics and Photo Lab	16,975	73,164
Retail Store	68,000	89,900
Loan Payback on Amphitheatre	0	44,800
Grants, Loans, and Contracts	1,191,939	708,233
Total Expenditures	$4,327,501	$4,848,303
Carry Forward to Next Fiscal Year	748,048	0
Total Uses of Funds	$5,075,549	$4,848,303

Source: IRRRB.

*As of June 4, 1984.

**Out of state travel funded out of the board account during FY 84 totaled approximately $49,500 and is contained within applicable activities listed above.

B. TEPF

Receipts of the TEPF are also annually available to the IRRRB. The TEPF receives taconite production taxes, the return of the unallocated school index funds, and interest and earnings. The amount available for spending each year is substantially larger than that in the board account. However, annual TEPF receipts vary considerably due to fluctuations in taconite production. In recent years, TEPF receipts have ranged from about $7 million to nearly $22 million.

All projects financed through the TEPF must be approved by the board, reviewed by the Legislative Advisory Commission, and approved by the Governor. The TEPF may be used for mineland reclamation, environmental studies, monitoring of work-related health problems among mining employees, and local economic development projects including but not limited to water, sewer, and public works projects.[3] In recent years, the TEPF has increasingly been used for economic development projects. For example, the fund paid for some of the construction costs of IRRRB's large tourism projects. In addition, IRRRB has also attempted to give priority to mineland reclamation and public works projects that may help stimulate economic development over other reclamation and public works projects. Development of abandoned mine pits into fishing lakes with campgrounds for tourists has accelerated in recent years. Water, sewer, and other public works projects that facilitate economic development or are of an emergency nature are now given priority over extension of public utility services to residential areas. Table 12.3 shows the TEPF receipts and expenditures during FY 1984 and budgeted figures for FY 1985.

C. NEPF

Unlike the board's general account and the TEPF, the IRRRB does not have full access to the Northeast Minnesota Economic Protection Trust Fund (NEPF). Established by the Legislature in 1977 in response to fears that the mining industry would eventually decline with devastating effects on the Iron Range economy, the fund was not to be spent until the year 2002 when it was projected that mineral reserves would be depleted.

However, due to the severe decline of the taconite mining industry in recent years, the Legislature appropriated funds from the NEPF to the IRRRB beginning in 1982. Through FY 1984, the IRRRB has received more than $30 million from the NEPF. Appropriations from the NEPF through FY 1984 include:

TABLE 12.3

TACONITE AREA ENVIRONMENTAL PROTECTION FUND:
RECEIPTS AND EXPENDITURES FOR FY 1984 AND FY 1985

Receipts	Actual FY 1984	Budgeted FY 1985*
Taconite Taxes	$ 4,881,520	$ 8,200,000
School Fund Index Return	1,217,079	1,200,000
Carry Forward	4,989,943	2,799,628
Interest Income	1,102,363	273,920
Total Receipts	$12,190,905	$12,473,548
Expenditures		
TEPF Administration and Engineering	$ 407,207	$ 524,518
Iron Range Trails	190,000	324,900
Iron Range Interpretative Center	1,329,939	2,222,780
Giants Ridge	0	2,300,000
Mineland Reclamation	1,267,500	1,672,460
Phased Projects	2,952,730	2,278,276
Available for Grants/Projects	3,180,901	2,815,850
Total Expenditures	$ 9,391,277	$12,138,784
Carry Forward to Next Fiscal Year	$ 2,799,628	$ 334,764

Source: IRRRB.

*As of June 4, 1984.

- $7.5 million appropriated during 1982 from the fund's interest and earnings for an emergency jobs program administered by the IRRRB and the Minnesota Department of Economic Security,

- $10 million appropriated in 1983 for economic development projects, and

- $13.2 million in accumulated interest and earnings on the fund appropriated for economic development.

The NEPF appropriations to IRRRB are for the purposes of "economic rehabilitation and diversification of industrial enterprises." The IRRRB is required by law to give priority to:

- Projects and programs that are designed to create and maintain productive, permanent, skilled employment, including employment in technologically innovative businesses;

- Projects and programs to encourage diversification of the economy and to promote the development of minerals, alternative energy sources utilizing indigenous fuels, forestry, small business, and tourism;

- Projects and programs for which technological and economic feasibility have been demonstrated;

- Loans, loan guarantees, interest buy-downs and other forms of participation with private sources of financing; and

- Funding reserve accounts established to secure the payment of the principal of and interest on industrial revenue or tax increment bonds issued by the IRRRB.[4]

In addition, the board may approve only those projects for which it finds that:

- "The project will materially assist, directly or indirectly, the creation of additional long-term employment opportunities;

- The prospective benefits of the expenditures exceed the anticipated costs; and

- In the case of assistance to private enterprise, the project will serve a sound business purpose."[5]

A project funded from the NEPF must be approved by at least eight of the eleven board members and the commissioner of the IRRRB. The project must then be reviewed by the Legislative Advisory Commission and approved by the Governor before funds may be spent.

The 1983 Legislature also required the IRRRB to prepare a long range economic development plan and present it to the Governor and the Legislature by January 1, 1984. The plan is primarily intended for use in determining the types of projects that can be funded by the NEPF. By law, the board can only use NEPF monies on those projects that are consistent with the goals and objectives of the long range plan. However, the plan is also useful for examining economic development projects funded from the TEPF and board account because it provides a summary of the IRRRB's general approach to economic development.

IRRRB's economic development plan identifies specific sectors of the economy that will be given priority for development through the use of IRRRB funds. The chosen sectors are those the IRRRB considers to be economic leaders--those that contribute to the economic base--rather than economic followers or support industries. The premise behind this policy is that, by developing basic industries, support industries such as retail and services will be maintained. The sectors identified by the IRRRB for targeting are:

- energy and alternative fuels,
- tourism,
- timber and wood products,
- mining and other industries based on the area's natural resources,
- industries that utilize new technologies, and
- industries that contribute to the diversification of the economy.[6]

These targets are largely based on the natural resources found on the Iron Range: peat and wood are abundant for energy production, the area is a scenic place for tourists, and forestry is already a dominant industry in the region. In addition, like other economic development agencies, the IRRRB would like to attract high technology businesses due to their high growth potential.

Table 12.4 shows the types of projects to which IRRRB has allocated the $30.7 million in funds received from the NEPF through FY 1984. It should be noted that, of the $7.5 million originally appropriated from NEPF interest and earnings for the emergency jobs program, only $5.2 million was spent on that program. After IRRRB received authority in 1983 to spend all of the past accumulated interest and earnings, the board decided to use the remaining $2.3 million to help finance the development of the Giants Ridge ski area.

TABLE 12.4

NORTHEAST MINNESOTA ECONOMIC PROTECTION TRUST FUND
ACTUAL AND BUDGETED EXPENDITURES*

Appropriations from the Corpus of the Fund		Appropriations of the Fund's Interest and Earnings	
Sources of Funds		Sources of Funds	
Special 1983 Appropriation for Economic Development Projects	$10,000,000	Appropriation of July 1982	$ 2,500,000
		Appropriation of December 1982	5,000,000
		Other Interest and Earnings (received as of 5/31/84)	13,231,976
Total Funds Available	$10,000,000	Total Funds Available	$20,731,976
Uses of Funds		Uses of Funds	
Common Bond Fund Reserve (for Industrial Revenue Bonds)	$ 5,000,000	Distressed Area Emergency Jobs Program	$ 5,211,278
Bank Participation Loans	3,481,430	Construction of the Giants Ridge Ski Area	2,288,722
Boiler Conversion Grants and Loans	1,493,800	Construction of the Energy Center at the Iron Range Interpretative Center	2,500,000
Total Expenditures	$ 9,975,230	Peat Development	1,850,000
		Boiler Conversion Grants and Loans	2,595,934
		Bank Participation Loans and Economic Consulting	1,200,581
		Administrative Costs	291,405**
		Total Expenditures	$15,937,920
Balance	$ 24,770	Balance	$ 4,794,056

Source: IRRRB.

*As of June 3, 1984.

**This figure represents actual administrative costs for FY 1983 and estimated administrative costs for FY 1984. IRRRB staff have since calculated that actual administrative costs in FY 1984 totaled approximately $100,000 less than anticipated.

Under current law, the IRRRB will also annually receive the interest and earnings of the fund. IRRRB staff estimate that an additional $4 million in interest and earnings will be available from this source for economic development projects in FY 1985.

At the end of FY 1984, the NEPF had a fund balance of slightly more than $27 million. Under current law, this $27 million--the remainder of the corpus of the NEPF--will be left intact. The corpus will grow as receipts from the taconite production tax are deposited annually. According to estimates from the Minnesota Department of Revenue, the fund will grow to about $28.8 million by the end of FY 1985.

NOTES

[1]Taconite production taxes are levied on a per ton basis. The state distributes these receipts to municipalities, school districts, counties, and other organizations in the taconite relief area to replace the revenues that could have been collected through the property tax. The IRRRB general account receives funding through the production tax distribution formula. The TEPF and the NEPF receive allocations from the receipts remaining after disbursements to Iron Range organizations have been made.

[2]Minn. Stat. §298.22, subd. 1 (3).

[3]Minn. Stat. §298.223.

[4]Minn. Stat. §298.292.

[5]Minn. Stat. §298.296, subd. 1.

[6]IRRRB, "Executive Summary," Northeast Minnesota Protection Trust Fund: Long Range Plan for the Economic Diversification of the Taconite Tax Relief Area, Eveleth, MN, January 1984.

Business Development

Chapter 13

The IRRRB has used a variety of business development tools in its effort to stimulate economic growth in Minnesota's Iron Range. These include: low interest loans, industrial revenue bonds, interest buy-downs, and feasibility studies and research. In addition, IRRRB management says that local development grants funded from the TEPF are now being more closely tied to economic development. This chapter examines the IRRRB's use of these business development tools including local development grants.

A. BANK PARTICIPATION LOAN PROGRAM

1. PROGRAM DESCRIPTION

Using funds from the NEPF, the IRRRB established a bank participation loan program to provide below-market-rate financing to selected business projects. The IRRRB provides up to half of the principal cost of a loan at an eight percent rate of interest while a private bank provides the other half at a market rate of interest. The IRRRB shares first position on collateral with the bank. Servicing of the loan is performed by the participating bank, which receives one-half of one percent interest from IRRRB for that purpose. Loans have generally been made for terms ranging from seven to fifteen years. Loan repayments are deposited in the NEPF and are available to IRRRB for use in this program or for other permissible uses of the NEPF.

Response to the program was overwhelming at the outset. However, many of the first applications were for retail projects rather than projects in targeted industries. Consequently, IRRRB management revised program guidelines in June 1983 to better reflect the development goals being drafted by IRRRB management. The types of businesses now eligible for the program include:

- resorts and tourism projects which attract tourism expenditures from outside the region,
- energy related businesses which utilize indigenous fuels,
- technologically innovative industries,
- manufacturing and industrial operations,
- industrial service and supply businesses,
- forestry and wood products businesses, and
- industries based on utilization of the area's indigenous mineral resources.

Eligibility is limited to these businesses because the IRRRB considers them to be "leaders" in the local economy rather than "followers." Similarly, the revised program guidelines list businesses considered to be "followers" and thus ineligible for the program. These include retail/service, construction, communication media, transportation, professional offices, speculative real estate, and agricultural businesses.

Program staff have developed a list of acceptable uses for the loan proceeds, including:

- land and building acquisition;
- land improvements;
- new building construction;
- building renovation;
- machinery and equipment purchase;
- expansion of resort facilities or upgrading of accommodations;
- working capital (but not a revolving line of credit);
- inventory purchase;
- limited refinancing of existing loans; and
- reasonable accounting, legal, architectural, engineering, and appraisal fees generated after approval of preliminary application.

Initially all refinancing projects were considered acceptable. After several refinancing loans were approved, however, it was decided that projects consisting entirely of refinancing should not be allowed since they do not contribute to economic growth. Revised program guidelines permit limited refinancing if accompanied by a business expansion, new job creation, or an improved collateral position for IRRRB.

The nature of the bank participation loan program requires coordination between the business applicant, a private lender, and IRRRB staff. Businesses must first complete a pre-application form describing the company and proposed project and documenting a bank's intention to participate in the loan. The pre-application process allows program staff to determine program eligibility while requiring the applicants to seek a participating lender.

Following a favorable review of the pre-application, the business submits its formal application for the program. This application requires:

- a more detailed description of the business;
- a business plan, which includes market analysis and product distribution plans;
- profit/loss statements;
- financial statements for the business principals;
- lists of major customers and suppliers;
- projections of the number of jobs to be created or retained by this project; and
- details of project financing, including the applicant's contribution.

This information is reviewed by a five-member Technical Advisory Committee consisting of three individuals with business or financial experience, a business management professor from the University of Duluth, and the IRRRB program manager. The committee reviews applications in light of the following criteria:

- job creation,
- diversification,
- technological and economic feasibility, and
- leverage ratio.

The Technical Advisory Committee makes its recommendations to IRRRB management, which transmits them to the board. The board must approve all bank participation loans. In addition, the loans must be reviewed by the Legislative Advisory Commission and approved by the Governor.

2. ANALYSIS

Through September 1984, the IRRRB has approved 45 bank participation loans requiring more than $5 million in financing from the NEPF. As of February 27, 1985, one loan was in foreclosure and four loans were delinquent. As Table 13.1 shows, about 30 percent of the total is for resorts and other tourism projects. Loans to businesses in the alternative energy field account for about 21 percent. Another 8 percent went to firms manufacturing forest products. The largest category includes loans to manufacturing, industrial supply and service, and other businesses not included in the other three categories. This category accounts for about 41 percent of the IRRRB funds for approved loans.

TABLE 13.1

LOANS APPROVED BY THE IRRRB FROM THE NEPF*

Targeted Sector	Number of Loans	IRRRB Portion of Approved Loans	Percentage of Total Dollars
Forest Products	3	$ 407,500	8%
Manufacturing/ Industrial Services and Supply/Other	18	2,167,650	41
Energy	8	1,086,700	21
Tourism	16	1,577,680	30
Total	45	$5,239,530	100%

*Includes loans approved through September, 1984.

Table 13.2 lists each of the approved loans and briefly describes the purpose of the loan. The table also identifies other known public financing and the number of jobs that loan applicants claimed would be created or retained as a result of the project.

TABLE 13.2

BANK PARTICIPATION LOANS[1]

Name of Business	Location	Project Description	IRRRB Loan	Other Known Public/ Nonprofit Financing[2]	Total Project Cost	Job Creation Claims
ENERGY LOANS						
Fenco (first loan)	Iron	Establish commercial peat harvesting, sales, and distsribution operation.	$ 75,000	Arrowhead Community Economic Assistance Corporation ($62,000)	$ 359,115	30 created
Fenco (second loan)	Iron	Restructure debt, working capital.	$ 25,000	Arrowhead Community Economic Assistance Corporation ($50,000)	$ 100,000	6 retained[4] 24 created
Aschon, Inc.	Aitkin	A privately owned district heating system. Loan is primarily for refinancing of existing debt and some new construction.	$276,000		$ 553,000	2 retained 10 created
American Bio-Energy	Gilbert	A wood pellet manufacturer. Project involves acquisition of building, new equipment, business start-up. IRRRB portion is for new equipment only.	$330,000	DEED loan insurance (80% coverage on a $1,500,000 private loan). Michigan Alternative Energy Board ($350,000 equity)	$2,430,000	10 created
Northern BioFuel	Crosby	Start-up of wood-peat pelleting company. Company also manufactures furnaces.	$153,200		$153,200+ applicant investment	5 created
Zenith Project	Ely	Private district heating system serving Vermilion College and a greenhouse.	$ 45,000	Office of Economic Opportunity grant ($100,000)	$ 255,000	3 retained
Lamppa Manufacturing[5]	Tower	Expansion to produce smokeless, wood-fired furnace for home heating.	$ 57,500		$ 115,000	4 retained 20 created
Power O' Peat[5]	Central Lakes	Produces horticultural peat. Loan is for equipment purchase.	$125,000		$ 125,000	12 created

Name of Business	Location	Project Description	IRRRB Loan	Other Known Public/Nonprofit Financing[2]	Total Project Cost	Job Creation Claims
FOREST PRODUCTS LOANS						
Cole Forest Products[3]	Grand Rapids	IRRRB loan is for working capital for use in marketing and log, wire and snowfence inventories. Total project expands company to produce compressed logs.	$ 85,000	SBA loan	$1,585,000	30 retained 15 created
Kingsley Wood	Palisade	Construct and operate a sawmill for pallet and cut-stock lumber	$240,000	City of Palisade (site improvements $2,300)	$ 907,000	3 retained 15 created
Northwoods Sawmill	Aurora	Expansion of sawmill to produce solid wood paneling.	$ 82,500		$ 165,000	6 created
TOURISM LOANS						
Bluefin Bay	Tofte (North Shore)	Construct condominium, restaurant, and bar.	$100,000		$ 750,000	70 created
Silver Rapids Lodge & Campground	Ely	Refinancing, restaurant, tennis court, increase number of rental units, recreation room, furnishings.	$175,000		$ 350,000	7 retained 9 created
Timber Trail Resort	Ely	Lodge addition and miscellaneous improvements.	$ 45,000		$ 90,000	6 retained 4 created
Superior Forest Lodge	Ely	Renovate lodge, build 2 cabins, shower-sauna building, purchase outfitting equipment.	$ 31,795		$ 63,590	5 retained 5 created
Roaring Stoney Resort	Babbitt	Upgrade facilities, begin float plane operation.	$ 30,000		$ 60,000	2 retained 3 created
Boundary Waters Canoe Outfitters	Ely	Refinance existing loan.	$125,000		$ 250,000	3 retained
North Country Canoe Outfitters	Ely	Purchase and refurbish resort, establish outfitting business.	$102,000		$ 314,000	7 retained
Ludlow's Lodge	Lake Vermilion	Construct cabin and recreational facilities, refinance existing loan.	$ 66,000		$ 132,000	3 retained 2 created

Name of Business	Location	Project Description	IRRRB Loan	Other Known Public/ Nonprofit Financing[2]	Total Project Cost	Job Creation Claims
Bearskin Lodge	Near Gunflint Trail	Build hot tub spa and staff living quarters.	$ 30,335		$ 60,670	7 retained 2 created
Cedarbrook Properties, Inc.	Deerwood	Develop hockey and figure skating facility by converting nursing home into dormitory and dining facility and constructing ice arena.	$152,125	SBA 503 loan ($250,000), Small Cities Grant ($200,000)	$ 900,000	40 created
Lodge of Whispering Pines	Ely	Mostly refinancing existing debt.	$ 75,000		$ 155,000	3 retained 1 created
Northern Aire Lodge	Ely	Build lodge addition, kitchen equipment, septic systems, refinancing.	$ 37,500		$ 75,000	2 retained
Pioneer Lodge	Ely	Build new hotel/lodge.	$375,000	Small Cities Grant ($200,000)	$2,336,444	35 created
Cliff Dweller	Lutsen	Construct a restaurant, purchase equipment and refinance loan.	$125,000		$ 250,000	3 retained 5 created
Shamrock Marina and Resort	Lake Vermilion	Refinance debt, purchase land and develop RV campground and other facilities.	$ 56,000		$ 112,000	4 created
Splithand Lake Development[3]	Grand Rapids	Construct lodge building at new resort/condominium.	$ 51,925		$ 103,850	9 created
MANUFACTURING AND OTHER LOANS						
Virginia Electronics	Virginia	New business start-up to manufacture solid state relay devices.	$ 50,000		$ 150,000	10 retained 28 created
Tire Retread	Virginia	Retreads tires on industrial equipment. Loan is for a boiler conversion, working capital, and refinancing.	$127,000		$ 255,000	6 retained 18 created
Minnesota Automation	Crosby	Manufactures cartoners and placers. This loan is for an expansion of their current facilities.	$238,000		$ 476,000	24 retained 18 created

Name of Business	Location	Project Description	IRRRB Loan	Other Known Public/Nonprofit Financing[2]	Total Project Cost	Job Creation Claims
Environmental Energy	Virginia	Manufactures densified fuel logs from waste wood, fire starters, and chemicals used in waferboard production. Loan is for refinancing and working capital.	$735,000		$1,500,000	20 retained 20 created
R.A.H. Sheetmetal	Grand Rapids	Relocate existing sheetmetal fabricator from garage to new building. Minor expansion involved.	$ 32,500		$ 75,000	2 retained
E.L.M. Industries[3]	Babbitt	Start-up of a business which will manufacture hot and cold pressure sprayers.	$ 50,000		$ 100,000	5 created
Northern Ductile Castings	Hibbing	Company produces grey iron and ductile castings. Loan is for purchase of new equipment and modernizing of facilities.	$100,000		$ 200,000	15 created
Pasta Works	Chisholm	Start-up of a company to produce "homemade" noodles.	$ 35,000		$ 100,000	10 created (9 of which are part time)
Fena and Laborde	Hibbing	Loan is to a real estate partnership to acquire land and building for leaseback to the Hibbing Electronics Company (HECO). HECO manufactures electronic assemblies for use in computer equipment, appliances, and toys.	$205,000	Wage subsidies from the Minnesota Emergency Employment Development (MEED) program; training assistance from the Minnesota Job Skills Partnership ($75,000)	$ 490,000	315 retained 75 created
American Hockey Stick	Mountain Iron	Expansion of hockey stick manufacturing operation from a cottage industry to a regular enterprise.	$ 80,000	Community Service Urban and Rural Community Economic Development Block Grant ($50,000); Enterprise Zone Credits	$ 210,000	2 retained 9 created
Economy Ready Mix, Inc.	Eveleth	Start-up of a ready mix company which will produce wash sand and rock, rebar, wire mesh, and ready mix.	$ 54,650		$ 109,300	9 created
East Range Machine	Aurora	Expand portable boring service operation to a manufacturing facility.	$ 32,500		$ 65,000	1 retained 3 created

Name of Business	Location	Project Description	IRRRB Loan	Other Known Public/Nonprofit Financing[2]	Total Project Cost	Job Creation Claims
Nelson/Williams, Inc.	Virginia	Company provides rubber application and urethane spray coating services for the mining industry. Project is for expansion of facilities, new equipment, refinancing, and working capital.	$ 47,500		$ 105,000	10 retained 3 created
MJN, Inc.	Chisholm	Take over of barbeque sauce production, packaging, and distribution from Red Owl companies. Sauce was initially developed by MJN's parent company.	$ 90,000		$ 180,000	10 created
Northland Fleet Service	Mountain Iron	Expansion and relocation of a maintenance company.	$ 58,000	SBA loan ($150,000); Enterprise Zone Credits	$ 268,000	5 retained 3 created
Air Glide	Tower	Start-up of company to produce fifth wheel mounts for semi-trailers. These mounts absorb shock, thus protecting cargo.	$130,000		$ 260,000	6 retained
Precision Dental	Gilbert	Expansion of dental lab to dental products. A mail order business.	$ 40,000		$ 91,281	1 retained 9 created
Northern Natural Industries	Hibbing	Company to produce grills and campfire rings for camping facilities as well as distributing turkey legs.	$ 62,500		$ 125,000	3 retained 5 created

Source: IRRRB.

[1]Includes all loans approved by the IRRRB as of September 1984.

[2]This listing may not be inclusive of all additional public financing as use of such programs as tax increment financing or enterprise zone tax credits may not have been noted in IRRRB files.

[3]These loans have since been cancelled by the IRRRB due to complications arising during project implementation.

[4]Only six jobs were created following the first loan to Fenco. It was claimed that the second loan would enable the firm to retain those six jobs and create the additional 24 jobs that the first loan was supposed to create.

[5]Both of these loans were approved by IRRRB prior to the establishment of bank participation loan programs and were also approved by the Northeast Minnesota Economic Protection Trust Fund Board, which existed for a short time during 1982 and 1983. The loan to Power O' Peat is technically not a bank participation loan since matching bank participation was not part of the loan package.

IRRRB's policy of providing financing only to the leaders of the local economy and not the followers is a good starting point for any economic development program. It is useful for eliminating from consideration those projects that are least likely to result in economic growth. However, the IRRRB's implementation of this policy needs more careful examination. We found that:

- Several of the bank participation loan projects would probably have been undertaken without a public subsidy.

- Others may have been given more subsidy than was necessary to cause the project to be undertaken.

- In several other cases, the IRRRB has not followed its policy of restricting eligibility to the leaders of the economy. Loans have been made to businesses that are highly dependent on the Iron Range economy or have competitors operating on the Iron Range.

- While the IRRRB has improved its policies on the use of loan proceeds for refinancing, further restrictions on refinancing are desirable.

- For these and other reasons, the number of jobs claimed to be created or retained by the program is overstated.

a. <u>The Need for Public Subsidies</u>

A public subsidy for an economic development project is not effective if the project would have been undertaken without the subsidy. If a project would have been undertaken anyway, the subsidy provides a gain to owners of a business without resulting in any net job creation for the economy. Also, if the total subsidies received by a business exceed the amount necessary for the project to be undertaken, the level of subsidy would be excessive. The benefits of the development could be achieved at a lower public cost.

Currently, IRRRB staff relies heavily on its revised program guidelines and the review of the lending bank to eliminate projects from consideration. However, neither the program guidelines nor bank review address the issues of 1) whether the project would be undertaken without public subsidy and 2) how much public subsidy is necessary to cause the project to be undertaken. Banks are primarily interested in whether the project is financially sound and whether the loan will be repaid. Banks prefer to finance projects with the lowest risk. Banks are less interested in financing projects that are marginal--that is, projects that would not have been undertaken without public subsidy. As a result, bank review will not screen out those proposals that would be undertaken without public subsidy or with less public subsidy.

The Technical Advisory Committee sometimes raises questions about the economic feasibility of a project or its job creation potential. However, the committee does not appear to consistently address these issues. Furthermore, the committee does not appear to play a significant role in determining which projects receive funding. Nearly all projects that meet program guidelines and receive bank financing are approved by program staff and the board.

Although it is often not easy to predict whether a project would be undertaken in absence of a public subsidy, we do not believe it is reasonable to fund every eligible business expansion without attempting to address the issue.

IRRRB program staff also need to more carefully examine the level of other public subsidies being given to firms applying for IRRRB loans. In a number of instances, firms receiving IRRRB loans also receive substantial public subsidies from local, state, or federal agencies. For example, a vehicle maintenance firm moving from one Iron Range city to another applied for a $58,000 loan from IRRRB, a $150,000 loan from the federal Small Business Administration, and state enterprise zone tax credits. The firm is also located in a tax increment financing district.

In another instance, a real estate partnership consisting of two officers of a local electronics assembly firm and their spouses received a $205,000 IRRRB loan to acquire land and an existing building, make improvements, and lease it back to the firm. This company was expanding for the third time and projected its employment would grow by 75 to 100 jobs. Prior to this expansion, it employed 315 workers. According to IRRRB files, the combined monthly debt service on the $410,000 loan (including both the IRRRB and bank financing) is approximately $5,610 per month. The real estate partnership receives $8,500 rent per month from the electronics firm. In addition, the firm pays all utilities and other costs associated with use of the building. The partnership invested $80,000 in the land and building and made improvements of $80,000 to $100,000 for which it is apparently receiving $2,890 per month ($8,500 less $5,610). In addition, the firm has received wage subsidies of $4 per hour over a six-month period for 82 workers that were added to the company's work force during this expansion and a prior expansion. The subsidy is being provided by the Minnesota Emergency Employment Development (MEED) program. The firm is also receiving the benefits of a $75,000 training grant made by the Minnesota Job Skills Partnership. The firm received a $600,000 federally approved loan to finance a prior expansion.

These two projects differ in their impact on the Iron Range economy. The electronics firm expansion is excellent news for the Iron Range. It provides a significant number of new jobs for the area's economy, brings dollars into the range economy because the firm sells its products outside the Iron Range and the state, and diversifies the Iron Range economy as well. The expansion of the vehicle maintenance firm is quite small in terms of its employment growth and is dependent on the local economy for its business.

According to the IRRRB program manager, staff does not routinely consider the question of how much subsidy is needed. However, in both of these instances and others, we believe it is essential for IRRRB staff to determine how much, if any, public subsidy is needed in order for an expansion to be undertaken.

b. Other Concerns

The program guidelines list the types of eligible businesses by economic sector. According to program staff, this was done in an attempt to target funds to leaders in the area economy. It is evident, however, from our review of loans that the program guidelines can sometimes permit loans to be made to: 1) firms that are dependent on the area's economy and 2) firms that compete with other area firms for business on the Iron Range. This is particularly true of firms who are classified as industrial service and supply businesses. This category includes firms that provide supplies and services to local companies as well as firms whose customers are largely outside the area or the state.

A distinction needs to be made among those firms that are highly dependent on the area's economy, particularly on the mining industry, and those firms that supply and service customers outside the area and are not dependent on the area's economy. In addition, the effect of subsidizing one area firm on other competing firms in the area needs to be considered. IRRRB's funds are best used on business ventures that bring money into the state and northeastern Minnesota rather than redistribute employment from one firm in the area to another.

The following are examples of loans for which greater staff review should have occurred:

- A $32,500 loan was made to a small sheet metal fabricator to enable the company to relocate existing operations from a garage to a new building. The company employed 1.5 full-time equivalent workers and claimed it would increase employment by another 1.5 employees. The firm is basically in the construction business and very dependent on the area's economy. In addition, according to its loan application, the firm has at least four competitors in the same general area.

- A $58,000 loan was made to a company that services vehicles for several public agencies and businesses in the area. The company had outgrown its existing building located in one iron range city (Gilbert) and was constructing a new building in another range city (Mountain Iron). The company's customers are located on the iron range and not likely to be served by firms outside the area. The expansion involved only 2.5 new jobs. The IRRRB loan was made contingent on the firm receiving a federal SBA loan of $150,000. However, the company also received enterprise zone tax credits and is located in a tax increment financing district. We wonder how much public subsidy is necessary to move this type of firm from one iron range city to another.

- A $47,500 loan was made to a firm that applies rubber applications, and soon urethane spray coatings, to mining equipment to prolong its life. In addition, the firm will also be receiving enterprise zone tax credits. According to the firm, 90 percent of its work is for local taconite mining companies. In light of the company's heavy dependence on the strength of the mining industry, one must question whether there are better uses for IRRRB's funds.

- A $54,650 loan went to a new business that will make ready-mix concrete for sale to the public and pour concrete for small residential projects. According to the company, nine jobs will be created. We question whether public subsidies should be used for such a project. The subsidized firm will be competing with existing firms in the area. Program staff contend that there is only one local competitor with two stores and that the additional competition has significantly reduced the price of concrete. Even if this is the case, it is questionable whether a public subsidy was necessary to spur additional competition. Furthermore, a downturn in the local economy could adversely affect both firms. Diversification of the Iron Range economy is not achieved through such a loan.

c. Refinancing

One of the earliest bank participation loans was used solely for refinancing and working capital. Refinancing is a passive use of loan proceeds for it does not necessarily result in any new development or economic activity. To their credit, IRRRB program staff recognized this and revised the program guidelines. Use of bank participation loans for refinancing is now permitted only if accompanied by some expansion.

However, this approach fails to recognize that in some cases a business may not need a public subsidy on the refinancing portion of the loan in order to undertake the proposed expansion. In other cases, refinancing may be necessary in order for the business to expand. Refinancing should not be permitted simply because some expansion is occurring. This issue is examined in more detail in Chapter 14 (Tourism Development) since use of refinancing has been more prevalent among loans to resorts.

d. Net Job Creation

IRRRB management has estimated that bank participation loans made by IRRRB have created approximately 500 jobs on the Iron Range and caused the retention of about 500 additional jobs. These estimates were obtained by merely adding all the jobs that each business receiving a loan claimed would be created or retained at their place of employment.

For a variety of reasons, these estimates overstate the job creation potential of the loan program. First, loans for projects that would have been undertaken anyway create no additional jobs. Second, loans made to firms that are not leaders in the area's economy are not likely to result in a net growth in jobs on the Iron Range.

Third, these estimates are based on the number of jobs that loan applicants claim will be created and retained. An applicant, knowing that job creation is a high priority for IRRRB, can increase the likelihood of receiving a loan by overstating the job creation potential of a project. Sometimes the applicant's audited financial statements reveal a discrepancy between job creation claimed on the application and future employment as projected by the applicant's accountants. In other cases, it later becomes known to program staff or others that actual employment growth is different than the applicant's original claims. Clearly, it is not reasonable to use the applicant's initial claims to measure the success of the program. IRRRB staff would need to follow up on its loans to see how many jobs are actually added by loan recipients. In fact, IRRRB staff is planning to follow up on the jobs added by loan recipients. We would caution, however, that even such a follow-up procedure would overstate the success of the program unless one: 1) excluded projects that needed no public subsidy to be undertaken and 2) accounted for the effect on any local competitors of loan recipients.

Finally, job retention estimates are greatly overstated. Loan applicants routinely report the number of workers they currently employ. Program staff usually count all existing jobs at a firm as retained jobs, implying that the firm would have gone out of business without the public subsidy. This is seldom true. Many of the projects are expansions designed to meet already increased demand for the company's products. In such cases, the company would at worst have to turn away customers, not eliminate existing jobs. In fact, it is questionable whether this type of project needs any public subsidy in order to be undertaken.

e. Recommendations

Many of the questions raised about the effectiveness of IRRRB's loan program are not unique to IRRRB. Many development agencies are subject to similar criticisms. However, we believe that it is in the best interests of IRRRB and other agencies to modify their project review process. In the case of the Iron Range, it is imperative that public subsidies be used wisely and be targeted to those projects that create the most jobs and would not be undertaken without subsidy from IRRRB.

We recommend that:

- IRRRB staff should revise their approach to loan review. In addition to reviewing the financial feasibility of a project, the review should consider: 1) whether the project would have been undertaken without the subsidy, 2) how much public subsidy is necessary for the project to be undertaken, 3) what effects the project will have on competing businesses on the iron range, and 4) whether the project is for a business that is dependent on the local economy.

- The Technical Advisory Committee (TAC) should focus its review on these four issues, as well as the financial feasibility of a project. To facilitate this review, the TAC should be expanded to include additional members with expertise in economic analysis.

- Job creation claims by loan applicants should be carefully scrutinized. Counts of retained jobs should be considered only in cases where it is clear that jobs would be lost if the loan is refused.

- As a general guideline, the bank participation loan program should provide 50 percent of the cost of new development only, rather than providing 50 percent of the total project costs. The IRRRB should participate in refinancing only in special situations in which refinancing improves the IRRRB's collateral position on a prior loan or is absolutely essential for a proposed expansion to occur.

Based on their experience over the last two years, IRRRB management believes that its loan program needs to undergo some additional changes. Management now believes that a bank participation loan program may not be the best way to stimulate economic growth. As pointed out above, the program attracts a number of loan applicants whose projects would likely proceed with private financing. The modest subsidy provided by the IRRRB's participation in the loan is not needed in such cases.

IRRRB management thinks the loan program should become involved with development projects in which its participation is more essential. Management would like to begin participating in some subordinated lending in which the IRRRB would no longer share first position with a bank. It is argued that the loan program can be more effective if it provides a subsidy to a project that is marginal rather than to a project that is able to receive private financing and proceed without a subsidy.

We generally agree with management's position. However, we are concerned that the IRRRB currently has few staff with the experience and training necessary to evaluate the financial and economic potential of proposed loans, particularly more risky loans. Provided that the IRRRB obtains the needed staff resources, we would support the IRRRB's making a limited number of such loans on a pilot program basis. The IRRRB should review the results of an initial pilot effort before committing substantial resources to a subordinated lending program.

B. INDUSTRIAL REVENUE BOND PROGRAM

1. PROGRAM DESCRIPTION

The IRRRB's industrial revenue bond programs supplement the bank participation loan program in supporting business development. The IRRRB can issue up to $25 million in bonds according to the state allocation formula. Beyond that, the IRRRB may submit projects to the state's competitive pool for funding.

There are two ways in which the IRRRB intends to issue industrial revenue bonds: either with or without the use of a common bond reserve fund. Bonds will be issued without use of a reserve fund when the companies receiving bond proceeds are large enough so that the bonds can be privately placed with banks outside the Iron Range. In that case, IRRRB funds do not need to be placed at risk. The primary benefit to private developers and bondholders is that interest on industrial revenue bonds is exempt from federal and state income tax. As a result, a developer is able to borrow funds at a lower interest rate.

One series of such bonds totaling $10,000,000--the maximum allowed by federal law--has been issued by the IRRRB up to now. The company, Louisiana Pacific, is constructing a wafer board plant in Two Harbors. The bonds were privately placed by Louisiana Pacific's bank. Additional public funding for the project was approved by Lake County (more than $100,000), the state of Minnesota ($400,000 of federal Small Cities Block Grant funds), the federal government (an EDA public works grant of $136,200 and a $1.4 million Urban Development Action Grant), and approximately $200,000 in IRRRB funds for an interest buy-down on an equipment loan. Total project cost is estimated at $16,500,000. The plant is expected to employ at least 100 workers.

The IRRRB also intends to issue industrial revenue bonds backed by a common bond reserve fund. The IRRRB has set aside $5 million from the NEPF for establishment of the fund. Since a reserve fund provides additional security for bondholders, lower interest rates can be secured for certain business projects. Companies receiving bond proceeds would be required to place an amount equal to one year's debt service in the fund for use as a primary reserve. In case of default, these funds would be used first to repay the bondholders. The $5 million in IRRRB funds would serve as a secondary debt service reserve to make payments on the bonds once the primary reserve has been exhausted. The project must reorganize during the time reserve funds are used for debt service payments. If a company's contribution to the debt service reserve remains unused during repayment, that money is used to make the final payments to the bondholders.

When developing the common bond reserve fund, IRRRB management negotiated with a private company to obtain insurance on each bond issue backed by the fund. The company agreed to insure one project but has since decided not to insure any additional projects. The main disadvantage of not obtaining insurance on future projects is that the IRRRB will not be able to withdraw the interest and earnings on its $5 million contribution for current use on other economic development programs. The interest and earnings on the $5 million will accrue in the reserve fund unless there is little demand for the program and management determines that the interest and earnings are not needed in the fund. One important advantage of a non-insured fund is that the IRRRB, not the insurance company, will determine which projects are supported through the common bond reserve fund. The IRRRB can thus set priorities for the program based on economic development goals rather than meeting the insurer's objectives. The insurer is not likely to be as interested as the IRRRB in whether the company requesting industrial revenue bond approval is a "leader" or "follower" in the area's economy.

Thus far, the common bond reserve fund has been used only once. Approximately $2.5 million in bonds were issued for the LP Medical Park Development project. This bond issue is the only one that a private company has agreed to insure. The project involves renovation and expansion of a medical office building in the city of Virginia. Space in the new facility will be leased by the developers (a limited real estate partnership) to LP Medical Specialists, Ltd., a medical clinic presently located in the existing building. It is anticipated that LP Medical Specialists, Ltd. will sublease 30 to 40 percent of the facility to other medical related firms. These include a health maintenance organization, an optical firm, a hearing aid company, a pharmacy, and others. Employment in the building is projected to include 37 full-time and 18 part-time workers. Since the project is basically a real estate venture, it could not have qualified for funding through IRRRB's bank participation loan program. Additional funding for the project will be provided by the city of Virginia ($600,000 in proceeds from tax increment bonds), the federal government (a $375,000 Urban Development Action Grant), and a $247,000 equity investment by the developers. Total project costs are expected to be approximately $3.7 million.

IRRRB also approved the issuance of industrial revenue bonds for a $3,500,000 expansion by Environmental Energy to expand the company's current fire log and resin manufacturing facilities. However, the potential insurer of the reserve fund viewed the project as too risky to insure. Subsequently, the company's bank in the state of Washington granted the company a letter of credit that would have enabled the IRRRB to issue revenue bonds for the project without using the reserve fund. The company, however, decided to undertake the project, which is expected to employ 45 new workers, with private financing. The company will be receiving some public subsidies through the state's enterprise zone program.

2. ANALYSIS

The issuance of industrial revenue bonds without using the reserve fund is a reasonable way for the IRRRB to attract very large companies in leading sectors of the economy and thereby stimulate economic growth on the Iron Range. It has been used once by IRRRB to bring a non-Minnesota firm to a very depressed part of the Iron Range.

According to various underwriting firms, the common bond reserve fund or some other type of credit enhancement is needed in order to permit the IRRRB and Iron Range cities to issue industrial revenue bonds that can be sold publicly. Without a reserve fund, bonds for most companies would have to be privately placed with local banks. According to underwriters, the advantages of publicly sold bonds are: 1) they can be issued at lower interest rates than privately placed bonds, 2) they can be issued for longer periods at fixed rates while private placements tend to be for shorter periods at variable rates, and 3) they bring money into the Iron Range because they can be sold to investors outside the Iron Range.

We believe the common bond reserve fund can be a useful economic development tool for the IRRRB as well as Iron Range cities. We note, however, that the first project to use the reserve fund is receiving other substantial public financing and may not result in net economic growth for the Iron Range. The medical services development is receiving $975,000 in other public financing in addition to the $2.5 million industrial revenue bond issue. The firms that will be located in the facility will provide services to consumers and will not be "leaders" in the Iron Range's economy. In light of the types of projects for which cities typically issue industrial revenue bonds, we do not think it was inappropriate for the IRRRB to issue bonds in this case.[1] However, we recommend that the IRRRB develop written guidelines for the use of their $25 million bonding allocation. Priority should be given to firms that are "leaders" rather than "followers".

C. INTEREST BUY-DOWNS

1. BACKGROUND

Interest buy-downs, one of the allowed uses of NEPF monies, can be used to reduce the effective interest rate on a conventional business loan. An interest buy-down can result in an interest rate lower than the bank participation loan program since the IRRRB could provide an eight percent rate on the entire amount borrowed.

The IRRRB has made use of interest buy-downs only once in the past two years. The buy-down was provided on a $5 million equipment loan for the Louisiana Pacific waferboard plant planned for Two Harbors. Under the agreement, the IRRRB will make one up-front payment of $201,498 to the company. This sum is equal to the present value of the difference between payments on a $5 million bank loan at 12.5 percent interest and payments at eight percent interest for the first five years of a ten year loan.[2] The company can then use the interest buy-down funds for their construction and start-up expenses.

Although only one interest buy-down has been made in recent years, IRRRB staff indicate that they see potential for increased use of this tool in the future. Rather than using interest buy-downs for expansion of local businesses, however, they plan to use them for attracting expansion of businesses from outside the Iron Range.

2. DISCUSSION

We agree with IRRRB staff that interest buy-downs should only be used to attract business expansions from outside the Iron

Range. In addition, the use of buy-downs should be restricted to: 1) firms who are leaders, not followers, in the economy and 2) projects that would not otherwise have been undertaken. In Part One of this report, we stated that state economic officials of DEED needed to become better negotiators when dealing with private businesses. This comment also applies to IRRRB management and staff who are attempting to attract businesses from other states. Negotiating with private businesses is not an easy task for public officials. However, we believe development agencies throughout the state need to be better prepared for the task and need training.

D. FEASIBILITY STUDIES AND RESEARCH

The IRRRB also funds feasibility studies and other research to encourage economic development. Funding for these studies can come from any of the three funds administered by the IRRRB. Due to the relative size of the funds, however, smaller projects are generally funded through the board account while larger, more expensive studies are funded through either the TEPF or the NEPF.

The IRRRB has funded a variety of studies bearing on economic development over the past years. Recent major studies include a study of the feasibility of a wood products industrial park, a research demonstration project for determining the feasibility of using taconite to produce steel using new technologies, and two projects researching the costs of peat production. The first two studies are discussed below. The peat research is discussed in Chapter 15.

1. BACKGROUND

The IRRRB hired Rural Ventures, Inc. for the study on the potential for a wood products industrial park in northeast Minnesota. The first phase of this study, costing $49,000, reported that such a park appears to be technically and economically feasible and that Hibbing is the best potential site. The second phase of the study, costing $58,000, will investigate the background of the wood products industry and the social, technical, financial, and market issues the project raises. The study will be used by IRRRB staff and Hibbing officials to provide companies interested in the project with information required for location decisions.

A key element of the wood products park would be a kiln to provide drying services for local sawmills. IRRRB staff believe that the kiln would attract businesses that use the dried wood in their production processes (such as a furniture manufacturer) to locate in the park. In addition, a district heating system fueled by sawmill waste would provide heat and electricity to the businesses locating in the park.

The IRRRB is also attempting to retain the market for the range's taconite mining industry by studying several potential technologies for producing steel and pig iron from taconite. Both plasma-smelt and coal reduction processes are being studied. The plasma-smelt project is a joint effort between Pickands Mathers, Westinghouse, Minnesota Power and Light Company, and IRRRB. It involves the development of a demonstration facility for producing steel and pig iron from taconite using plasma-smelt technology. This process is relatively new for steel production and utilizes electricity rather than coal. If this process is technically and economically feasible, a commercial production plant could be developed, resulting in increased demand for Minnesota taconite. IRRRB participation in this project is limited to $1,375,000. The IRRRB funds, which come from the TEPF, will be spent over a two-year period and will be used for operation expenses and additional research. If a commercial plant is built before May 1, 1992, the IRRRB funds must be repaid with interest. Otherwise, repayment is not required.

A second effort to develop steel production on the Iron Range was a market and transportation study that assessed the potential markets for pig iron and slab steel produced on the Iron Range using a coal reduction process (the K-R process). The study also accounted for the costs of transport from Minnesota to final destinations. In conjunction with the IRRRB-funded study, the Minnesota Department of Natural Resources funded a technical feasibility study of the K-R process. Together, the results of these studies will be contained in an application for a federal grant to fund a mini-steel mill demonstration project. A German firm that already utilizes the K-R process has indicated interest in operating the mill.

2. DISCUSSION

IRRRB's investment of funds in both the wood products study and the new steel technology studies make sense. A study conducted by the University of Minnesota's Northeast Minnesota Task Force concluded that efforts should be made to develop secondary forest products industry--companies that produce intermediate or final wood products--on the Iron Range. Currently, most of the timber harvested in the area is shipped elsewhere for processing into final goods. As a result, most of the jobs based on Minnesota's wood resources are based in other parts of the country.[3]

The studies of new steel production technologies could, if successful, enable the Iron Range to retain thousands of existing jobs in the taconite mining industry. The University of Minnesota task force concluded that new direct smelting techniques such as those now being studied by the IRRRB could have a significant economic impact.[4]

Some words of caution about these projects are appropriate. The wood products study is only the first step in the process of developing a wood products park and the secondary forest products industry. It is likely that firms wishing to locate in the park will request public subsidies. The Hibbing site has already been declared a state enterprise zone for this purpose. In addition, such companies would be eligible for either the bank participation loan program or the bonding program administered by the IRRRB. It would be wrong to conclude that the IRRRB's feasibility study itself will bring about the park's development. Rather, IRRRB staff are hoping it will serve as a catalyst. As a result, it is important for IRRRB staff to ensure, before the park is developed, that public subsidies are used only to attract development that would not have otherwise occurred and that firms receiving subsidies have a good chance of succeeding in the intermediate or final wood products markets.

Regarding the steel production studies, there is some controversy over whether Minnesota's Iron Range could compete with Brazil or eastern Canada using the plasma-smelt process. A University of Minnesota professor recently concluded that northeast Minnesota would not be competitive.[5] Minnesota Department of Natural Resources (DNR) officials are convinced that some of the assumptions made in that cost comparison are not accurate. As a result, they believe northeast Minnesota could be competitive.

At this point, it is unclear how competitive Minnesota would be. The demonstration project will hopefully clear up some of the confusion. However, it is imperative that state DNR officials and IRRRB staff ensure that public funds not be used for further development unless economic analyses indicate that northeast Minnesota will be competitive in national and international markets.

E. LOCAL DEVELOPMENT GRANTS

1. PROGRAM DESCRIPTION

The IRRRB administers a grant program funded from the TEPF for local development projects. Local governments within the taconite tax relief area have come to rely on this program for assistance in meeting their infrastructure needs. The IRRRB's emphasis on economic development, however, has recently influenced this program's funding priorities. As a result, the local development grant program is becoming more closely associated with economic development. For example, a sewer and water project to provide service to a planned business development site will now be given priority over a similar project in a residential area. Criteria for project review now include:

- the job intensity of the development served by the local project;
- the level of emergency need for the local project; and
- the "leverage ratio" of the project, meaning that amount of financing provided by other sources in relation to the requested IRRRB funds.

The TEPF grant program begins accepting project applications at the start of the fiscal year, and projects are approved on a first-come, first-served basis. IRRRB staff contend that this process allows them to better control the amount of spending through this fund. Actual payment of grant funds to local governments is not begun until March, when the TEPF receives its share of production tax receipts.

Since the IRRRB staff accept applications for TEPF grants throughout most of the year, some applications are submitted almost a year in advance of project construction. IRRRB staff believe that this process makes it difficult for applicants to accurately estimate project costs. Consequently, applicants are allowed to request further TEPF funding for cost overruns. These requests go through the same review and approval process as initial grant applications, thus allowing the board to be informed of the causes for the overruns. Generally, all overrun requests receive funding and applicants are not required to contribute to overrun costs. Approximately $92,000 was spent for cost overruns during FY 1984.

2. ANALYSIS

Our examination of the grants for FY 1985 approved by September 1984 indicates that there are a number of problems with the grant review process. In order for the IRRRB to redirect this program to serve economic development goals, it will need to make some changes in the process. The problems include the following:

- The first-come, first-served method of grant approval lends itself to the approval of some lower priority projects, possibly at the expense of high priority projects submitted later in the year.
- IRRRB staff lack meaningful definitions of their three review criteria.

- IRRRB funding of emergency projects may reduce local incentives for routine infrastructure maintenance.

- The TEPF grant program lacks a clear policy on local matching contributions.

- Current cost overrun policies reduce incentives for grant recipients to control project spending.

According to IRRRB staff, the first-come, first-served basis for funding projects is supposed to help control program spending. However, without being able to compare and contrast the grant applications in light of the program criteria and IRRRB policy goals, some low priority projects may be approved early in the funding cycle at the expense of high priority projects submitted after all the available grant monies have been committed. In addition, it may be better for the IRRRB to save the TEPF funds for future use rather than commit them to low priority projects. Funding projects on a first-come, first-served basis encourages approval of projects submitted early in the year. This does not necessarily result in effective use of TEPF monies.

The IRRRB adopted the three criteria for project review--job creation, emergency, and leverage--to deemphasize infrastructure projects that do not contribute to economic development. However, our review of the FY 1985 grant files indicates that several projects have been approved for funding that do not meet any of the criteria. For example, one grant was given to an Iron Range town for renovation of the town hall kitchen. Since this project leveraged little outside funding (90 percent of the project was funded through the TEPF), and the project will not result in any increase in employment, the project could only be justified through the emergency criterion. Regardless of how much the kitchen was in need of repair, considering this project to be an emergency seems excessive. Approval of this type of project weakens the legitimacy of the grant program's evaluation criteria.

Requiring an "emergency" as one of the criteria for eligibility is a good step but it may encourage applicants to forego routine infrastructure maintenance. Recently, the board received a number of requests for water tower repairs. The board voted to investigate these water tower repair proposals since the number of such proposals had sharply increased and the same engineering company was to perform the repair work on most of the towers. The board questioned both the emergency nature of this work and whether the cities had adequately maintained the towers to avoid the need for emergency funding. While this action indicates that the board is aware of the problems with the emergency criterion, a better definition of "emergency" is needed.

Other matching funds are one of the three criteria now used for this program. This is a change from past policy, when nearly all local development projects were funded completely with TEPF grants. However, we found that 46 percent of the FY 1985 grants approved as of September 1984 were completely financed by IRRRB. Similarly, some local governments indicated on their application that they had not sought outside sources of financing other than the TEPF money. In one case, the applicants indicated that they would contribute 10 percent of project costs, yet the grant request presented to and approved by the board was for full project costs. These findings indicate that the change in policy on local contributions has not been fully implemented.

A related problem exists in the IRRRB's policy of funding cost overruns. Currently, local governments do not have sufficient incentives to accurately estimate project costs or to control costs during construction because IRRRB will fully fund cost overruns.

3. RECOMMENDATIONS

We agree with IRRRB management's intention to use the local development grant program to stimulate economic development. We believe the IRRRB should continue to change its role from a regional government redistributing funds for local infrastructure projects to an economic development agency. Economic development objectives can be better addressed at the regional or state level, not the local level. Non-development objectives, such as those largely served by this program in the past, are better addressed by local governments.

We recommend that:

- The IRRRB gradually restrict this program to funding projects that will assist and help stimulate economic development. Non-development related projects should not be approved simply because they are submitted earlier in the year.

- IRRRB staff should attempt to better define the criteria used in project review.

- The IRRRB needs to establish a clear policy on local matching funds. The policy should not put unreasonable demands on the local governments seeking funding. It should, however, require enough local commitment to indicate that the project is a local priority.

- The IRRRB should change its policy of completely funding project cost overruns by requiring a local contribution on cost overruns. This change would provide local governments better incentives to accurately estimate project costs and to control costs during construction.

NOTES

[1]According to Department of Energy and Economic Development data for 1983, more than 75 percent of authorized industrial revenue bond financing in Minnesota was for commercial projects.

[2]A ten percent discount rate was used in the present value calculation.

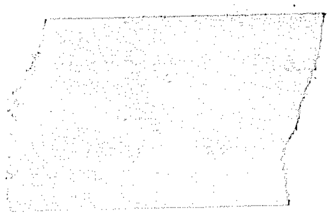
[3]See the Northeast Minnesota Task Force's summary report and Bowyer, James L., Forest Products in Northeast Minnesota: Opportunities for Industrial Expansion, University of Minnesota, April 1984.

[4]See the task force's summary report, p.9, and see Reid, K.J., Economic Development in Northeast Minnesota: The Potential in the Mineral Sector, University of Minnesota, June 1984.

[5]Reid, Kenneth and Peter Kakela, "The Influence of International Location in the Competitive Posture of Two New Technologies," Journal of Metals, December 1983, pp. 31-38.

Tourism Development

Chapter 14



Another strategy used by the IRRRB to stimulate the Iron Range area's economy is to develop its tourism industry. During the late 1970s, the IRRRB's strategy for increasing tourism relied primarily on the Iron Range Interpretative Program. Under this program, the IRRRB invested approximately $8 million to construct the Iron Range Interpretative Center at an abandoned mine site near Chisholm, Minnesota and to develop several other abandoned mine sites. These sites promote the history of iron mining and attract tourists through museum exhibits such as those at the Iron Range Interpretative Center, tours, or scenic views of the mines. Between 1974 and 1980, the IRRRB also granted nearly one million dollars to various other tourism facilities in northeastern Minnesota, including the Paulucci Planetarium, the Forest History Center, the previous Giants Ridge ski facility, and the United States Hockey Hall of Fame.

Beginning in 1983, the IRRRB greatly expanded its efforts to develop the tourism industry in northeastern Minnesota, particularly in the Iron Range area. Significant recent investments in tourism development include:

- An $8.5 million expansion of the Iron Range Interpretative Center;

- A $6.9 million redevelopment of the Giants Ridge ski area;

- Over $1.5 million in low interest loans to private tourism facilities;

- Operation of the Paulucci Planetarium, including a $75,000 investment in a new projection system;

- An increased tourism promotion budget now totalling approximately $290,000; and

- Development of campground and recreational facilities at abandoned mine sites at a cost of $820,000 over the past five years.

Other IRRRB tourism activities include, but not limited to:

- A $49,000 fish-stocking program for lakes in abandoned mine pits;

- An expanded program with a fiscal year 1985 budget of about $176,000 for developing and maintaining year-round, multiple-use recreational trails;

- Grants for local tourism events budgeted at $65,000 for fiscal year 1985; and

- Mine tours at the Hill-Annex Mine.

Future tourism development plans being considered include:

- Construction of a $1.8 million science museum and a $2.0 million historic mining village at the Iron Range Interpretative Center;

- Possible public subsidies to private developers to build a hotel complex adjacent to the site of the interpretative center; and

- Development of the Giants Ridge facility into a year-round training center and tourism attraction.

In the remainder of this section, we examine the economic development potential of the IRRRB's major expenditures on tourism development. We focus on the expansion of the Iron Range Interpretative Center and the development of the Giants Ridge ski area and plans for further development of those facilities. In addition, we examine the Paulucci Planetarium, the tourism loan program, tourism promotion expenditures, and the development of campgrounds and recreational areas.

A. IRON RANGE INTERPRETATIVE CENTER

The Iron Range Interpretative Center (IRIC) overlooks an abandoned open pit mine near Chisholm, Minnesota. When the center opened in 1977, it featured "hands-on" exhibits of iron mining and the history of the Iron Range area. Between 1977 and 1981, the IRRRB added a Hall of Geology, a library and research center, and an ethnic arts center to the interpretative center. Constructing the original center and these additions cost $5.7 million. Funding sources included the IRRRB ($3.6 million), the state ($0.5 million), the United States Economic Development Administration ($0.5 million), the Upper Great Lakes Regional Commission ($0.7 million), and various non-profit organizations ($0.4 million).

Originally, the interpretative center was intended to meet educational and historical objectives as well as tourism development objectives. The center was designed to educate the public about iron mining and the history of the Iron Range area and to preserve historical records. The purpose of the IRIC library and research center is almost entirely educational and historical. It collects, restores, and preserves historical documents involving the Iron Range's history. It serves primarily academic persons and those who want to trace their genealogical background. Few tourists use the research center's services.

In October 1984, the IRRRB closed the interpretative center to complete a major expansion of the center. It is scheduled to reopen in spring 1986. The main purposes of this expansion are to attract more tourists to the Iron Range area and to reduce the center's operating deficit. The IRRRB has already committed approximately $8.5 million towards this expansion, including:

- $2.5 million to construct an energy building, retrofit the interpretative center complex, lay connecting pipes, and plan the construction of a science museum on the floor above the energy building;
- $2.25 million to construct an outdoor amphitheatre with nearly 1,800 seats and a total capacity of approximately 3,500;
- $1.8 million to construct a parking lot and an entrance control building that will house the center's administrative offices and a tourist information center;
- $1.6 million to construct a railroad from the interpretative center to the other side of the mine pit and to purchase a vintage train;
- $100,000 to begin constructing a pedestrian park in front of the main building; and
- $200,000 to expand the Ethnic Center.

The IRRRB is funding most of the cost of these projects. The state is contributing $200,000 for the tourist information center and $1,120,000 for the amphitheatre, of which $448,000 is an interest free loan that must be paid back to the state by the IRRRB over the next ten years. The federal government is also contributing $600,000 for the parking lot.

Future development plans which have not yet been approved by the IRRRB include completion of the pedestrian park at a cost of $300,000, construction of a $1.8 million science museum, and construction of an historic mining village over several years at a total cost of approximately $2.0 million. The village would be located on the other side of the mine pit and would be reached via the railroad. Preliminary village plans call for constructing shops in which arts and crafts will be made and sold to tourists. The IRRRB also wants private investors to build a hotel overlooking the mine pit adjacent to the interpretative center. It is not yet clear how much public subsidy would be required to attract private investment for the hotel.

1. ANALYSIS OF EXISTING INTERPRETATIVE CENTER OPERATIONS

In this section, we examine the existing interpretative center and its past contribution to the economy of the Iron Range area. As a tourist attraction, the center's contribution can be measured by comparing the center's costs (operating and capital) to its revenues plus the additional spending by tourists attracted by the center to the Iron Range area.

We realize that the interpretative center has educational and historical objectives as well as economic objectives. As a result, the center's success cannot alone be measured in monetary terms. Historic sites in the state are not generally expected to break even. The 31 historic sites operated by the Minnesota Historical Society require approximately $2.5 million per year in state appropriations to meet operating expenses. For example, historic Fort Snelling's operating costs were $439,000 in FY 84 whereas its admission revenues were only $70,000. The difference between its revenues and expenses would be much larger than $369,000 if a portion of the fort's recent $7.1 million capital improvement costs were also included. Whether the fort or other historic sites generate enough tourism spending to justify their operation is a question that is rarely asked.

However, it is useful to examine the economic contribution of the Iron Range Interpretative Center for several reasons. First, some of the special events now held at the center are usually justified on the basis of their ability to attract tourists. Second, much of the current and proposed expansion of the center is being justified by its potential contribution to the Iron Range economy. It is useful to review the present impact of the center on area tourism before examining the effect of the expansion.

To evaluate the center's impact on the economy, one needs to know the center's revenues and expenses and the additional spending in the Iron Range area by tourists who are attracted to the area by the center. The center's operating revenues and expenses are known but the amount of additional tourist spending is not. During fiscal year 1984, the interpretative center cost $1,219,000 to operate, including approximately $252,000 for the research center's expenses. During the same period, the interpretative center's operating revenues were about $140,000, resulting in an operating loss of approximately $1,079,000. Excluding the research center, the operating deficit would be $827,000.

Unfortunately, little is known about the impact of the center on tourism. Interpretative center management lacks good information on where the center's visitors are from. Management also does not collect information on why visitors from elsewhere come to the Iron Range area or on how much money they spend in the area.

Existing information on where visitors are from includes guest registration listings and a voluntary survey conducted by the interpretative center in August 1984. Guest registration data indicates that the percentage of visitors who are from the Iron Range area was 24 percent during ethnic days (a special festival running from August 1 through August 12) and 12 percent during the remainder of August. Survey data indicate that 13 percent of visitors were from the Iron Range area during August, and 42 percent were from other states.

However, neither the guest registration data nor the survey data appears to be representative of all visitors to the interpretative center. Attendance data shows that 29 percent of visitors during August were IRIC season ticket holders. It is unlikely that the percentage of visitors from the Iron Range area would be less than this percentage since most season ticket holders are from the Iron Range area. Furthermore, neither the guest registrations nor the survey are based on a random sample of the center's visitors. Less than ten percent of visitors sign the guest register and out of town visitors are probably more likely to sign the register than local visitors. Similarly, out of town visitors probably were more likely to complete the survey than local visitors. Survey forms were distributed in the ethnic arts center during August. Many visitors come just to see the outdoor entertainment during ethnic days and thus would not be surveyed. Local visitors are more likely to have seen the inside exhibits on previous visits and thus would be more likely to just come for the outdoor entertainment.

Attendance data are somewhat more useful for examining the economic impact of the center. These data indicate that the interpretative center has probably not attracted many tourists to the Iron Range area except during certain special events--particularly the annual ethnic days celebration and the international polkafest held at the center this past summer. Total attendance at the interpretative center grew from nearly 79,000 in 1978 to approximately 120,000 in the year ending August 31,

1984. The two main reasons for this growth were the ethnic days celebration which was first held in 1979, and the international polkafest that the interpretative center hosted for the first time in 1984. Attendance at these two events was approximately 52,000 in 1984. Attendance for the year ending August 31, 1984 is summarized in Table 14.1.

However, attendance figures for the interpretative center include many persons who are not tourists. The 120,000 attendance for the year ending August 31, 1984 included the following non-tourist categories:

- Approximately 8,000 persons who drove by the center to see a Christmas light display;
- Approximately 10,000 school children on field trips;
- Approximately 21,000 visits by season ticket holders; and
- Approximately 14,000 repeaters, vendors, entertainers, and persons attending special meetings (most of these were repeaters--persons who entered the center more than once on the same day).

The remaining 67,000 were regular paid admissions to the center. This includes both tourists from outside the Iron Range and persons from the Iron Range area who are not season ticket holders. There are many reasons why tourists at the interpretative center may have come to the Iron Range, including visiting friends or relatives, and traveling through the area to visit another destination. Thus, even if most of the regular paid admissions were tourists, the number of tourists actually drawn to the Iron Range area by the interpretative center would be considerably less than 67,000.

In fact, it is unlikely the interpretative center generates enough tourist spending in the area's economy to cover its operating deficit. Excluding attendance during ethnic days and the international polkafest, there were only 39,000 paid admissions during the year ending August 31, 1984. If even one fourth of these admissions were tourists who came to the Iron Range area because of the interpretative center and spent an average of $30 per person in the area, they would have spent $292,500. This is less than the interpretative center's operating deficit (excluding the research center) minus the net costs of ethnic days and the polkafest.

However, ethnic days and the international polkafest may have successfully attracted tourists to the Iron Range area. Ethnic days are held during 12 days in August. Each day features crafts, exhibits, dancing, and music of a different ethnic group from the Iron Range area. During 1984, attendance during ethnic

TABLE 14.1

ATTENDANCE AT THE IRON RANGE INTERPRETATIVE CENTER

During the Year Ending August 31, 1984

	Ethnic Days[3]	International Polka Fest[4]	Remainder of Year	Total
Paid Attendance	19,173	9,118	38,732	67,023
Season Ticket-Holder Attendance[1]	9,510	5,196	6,310	21,016
Free Admissions[2]	6,242	2,455	23,007	31,704
Total	34,925	16,769	68,049	119,743

[1]Season tickets are $10 per year for individuals, $15 for families, and $5 for senior citizens. Season ticket-holders have been entitled to free year-round admission and other benefits.

[2]Included are approximately 10,000 students on school field trips, 7,887 drive-through visits for a Christmas light display, and approximately 14,000 repeat visitors, vendors, entertainers, and persons attending meetings or other events.

[3]Ethnic Days were held from August 1 through August 12, 1984.

[4]The International Polkafest was held on June 29 through July 1, 1984.

days was 34,925, including 19,173 paid admissions, 9,510 season ticket admissions, and 6,242 free admissions. The season ticket holders are mostly local people but it is not clear how many paid admissions were local people.

The costs directly attributable to ethnic days in 1984 were $75,000, including $47,000 for entertainment and $17,000 for advertising. These costs do not include normal operating expenses such as salaries of interpretative center employees or building maintenance. The 1984 operating revenue was about $42,000. While there was a net operating loss of at least $33,000, this does not mean that ethnic days was a poor investment for the IRRRB. If a moderately large proportion of ethnic days visitors are from outside the Iron Range area, the spending by these tourists could be substantially higher than the operating loss. For example, if only one-fourth of the paid admissions during ethnic days came to the Iron Range area specifically because of ethnic days and these visitors spent $60 per person, then about $288,000 would have been spent in the area.[1] This is an amount almost seven times the net loss incurred during ethnic days.

The international polkafest was held June 29 through July 1, 1984. The attendance was 16,769, including 9,118 paid admissions, 5,196 season ticket admissions, and 2,455 free admissions (mostly repeaters). The direct operating costs to the IRRRB were $30,000 and the revenues were $22,000. Again, the $8,000 operating loss is small compared to the potential gain in tourist spending. If one-fourth of the paid admissions were tourists who came to the Iron Range area specifically because of the polkafest, and they spent $60 each in the area, total tourist spending would be about $137,000--far in excess of the board's operating deficit of $8,000.

Furthermore, the IRRRB is currently reviewing its admission prices particularly those charged during events such as ethnic days when live entertainment is provided. The board intends to raise ticket prices when it reopens the interpretative center in 1986. Currently, adults pay only $1.50 and children $1.00. Ticket price increases could eliminate the operating deficits incurred during special events, but will not eliminate deficits incurred during the remainder of the year.

In conclusion, the existing center probably does not generate enough tourist spending to cover its operating deficit. However, certain special events that feature live entertainment have probably generated tourist spending that is several times the IRRRB's net cost of operating those events.

2. ANALYSIS OF THE INTERPRETATIVE CENTER'S EXPANSION PROGRAM

The main purposes of expanding the interpretative center are to stimulate tourism in the Iron Range area and to reduce the center's operating deficit. The IRRRB believes that, by expanding the number and variety of exhibits and building the old town and railroad, the interpretative center can hold tourists for four or more hours rather than about one hour. Consequently, tourists may be more likely to stay and spend money in the Iron Range area. Also, more tourists would likely be attracted to the area. However, we found that:

- IRRRB management has not adequately analyzed whether this major expansion program will generate sufficient tourism benefits to justify its costs.

The director of the center contends that attendance will increase from 130,000 to 350,000 after the expansion program, including the historic village, the science museum, and the hotel is completed.[2] His estimate is based on an informal estimate offered by a consultant whose firm designed many of the interpretative center's existing exhibits and has been hired by the IRRRB to design exhibits for the current expansion. This estimate is questionable for a number of reasons. First, the IRRRB did not ask the consultant to conduct a market analysis or feasibility study of the expansion program. Instead, the consultant estimated the attendance on the basis of the 130,000 attendance the center has already achieved and his judgment that attendance would more than double if the IRRRB completes the planned development and increases its promotion of the center. However, as we showed earlier, the 130,000 attendance figure overstates the actual number of visitors to the center and tourists account for substantially less than half of this attendance. The actual number of tourists depends on how many of the 67,000 paid admissions are tourists rather than local people. Second, such an analysis should be conducted by an experienced market analyst who is not otherwise involved in the center's development. The consultant who made the estimate specializes in planning and design, not market analysis. In addition, an estimate should be made by a non-interested party rather than a consultant whose firm is benefiting from the expansion. Finally, estimating attendance is not enough. The IRRRB has not analyzed how many of the additional visitors would be from outside the Iron Range area, whether the interpretative center would influence them to come to the Iron Range area, how long they would stay, and how much money they would spend while in the area. Since completing all proposed improvements will cost over $12 million plus any subsidies offered to a hotel developer, these improvements should have received more thorough analysis.

The closest the IRRRB came to analyzing the feasibility of a proposed improvement to the interpretative center was a consultant's study of the railroad proposal. The study estimated the construction costs and the operating costs and revenues of the railroad. It found that 50,000 riders would generate enough revenue to cover the operating costs. The study estimated that

100,000 persons would ride the train each year, generating a "net" income of $77,000 per year.

However, it did not compare all of the benefits (including spending by tourists attracted to the Iron Range area by the project) with all of the costs (including capital costs as well as operating costs). All of the major cost and benefit categories should be examined to determine if the proposal is a good investment. Moreover, it is unclear how the estimate of railroad ridership was obtained. On the one hand, according to the study, the estimate "is based upon the historical experience at the Interpretative Center and a projection of future growth, estimated to reach 375,000 upon completion of a number of new attractions planned for the Center, namely: The Amphitheater, the Energy and Science Museum, the Mine Location Village and the Tourists and Convention Hotel and Recreation Area."[3] On the other hand, the consultant responsible for the study has told us that his ridership estimate was based only on the center's current attendance and the increase expected because of the railroad without considering any impact from the additional development taking place at the center. Because the consultant's statement contradicts the railroad study report, we believe it necessary for the IRRRB to reexamine the impact of the railroad on attendance. Considering the experience with the monorail at the Minnesota Zoo, we also believe that one should have a good estimate of overall attendance before one projects ridership on a ride such as the railroad.

The proposed science museum component of the science and energy building would consist of exhibits about energy, computers, biotechnology, medical technology, communications, food, and agriculture. While this component is consistent with the educational objectives of the interpretative center, its ability to attract large numbers of tourists to the Iron Range is questionable.

Another rationale for expanding the interpretative center is that tourists who are passing through the Iron Range area would more likely stay overnight in the area if the interpretative center could "hold" them for an extended time (more than four hours). The validity of this argument depends on how many tourists passing through the Iron Range area stop at the interpretative center and want to stay longer to see the additional exhibits. It also depends on how much money tourists passing through are willing to spend in the area.

Many of the tourists passing through the Iron Range area are pursuing active outdoor vacations in northern Minnesota. It seems unlikely that many of these tourists would have the interest and time to spend most of the day at passive interpretative center exhibits. Moreover, even if "pass-through" tourists stay overnight, their spending would be small compared to what tourists normally spend at their destination. For these reasons, we believe that the IRRRB should have established the viability of the pass-through market before it used this rationale to justify expansion of the interpretative center.

One part of the science and energy building has already received funding. The IRRRB is constructing a $1.8 million energy building that will provide energy to the entire complex by burning wood or peat. This includes existing buildings that previously used electric heat, buildings under construction (the administrative building and the energy building itself), and the proposed science museum and hotel. The first year's energy savings from heating all these buildings except the hotel are estimated to be only about $60,000--a very small return on a $1.8 million investment. However, the director of the center points out that the cost of the energy building is higher than it would have been if the building were needed only for energy savings purposes. The energy building is the first floor of the planned science and energy building. The energy floor is being built so that the alternative energy operation can be viewed by visitors. Also, part of the capital costs of the energy floor should be considered a subsidy to any developer of the proposed hotel, since the IRRRB would extend service from the building to the hotel.

The director of the center has not yet provided us with an estimate of the additional costs incurred because the energy floor will be an exhibit area. In addition, the potential cost savings for the hotel development are not yet known. Consequently, we are unable to determine whether the facility is beneficial from an energy savings point of view.

The interpretative center's expansion plans also include a proposed private full service hotel development adjacent to the interpretative center complex. The IRRRB may soon have to decide whether to invest public funds to support this proposed development. To determine the feasibility of a hotel development, the Friends of the Interpretative Center hired a consultant to conduct a market study and make financial projections for the proposed development. The consultant concluded that the proposed hotel "would be marginally successful and would require favorable financing conditions in order to be economically feasible."[4] The favorable financing conditions may require additional public subsidies by the IRRRB, local communities, or the state. The consultant's analysis assumed that the IRRRB would build an 18 hole golf course, a skating rink, and recreational ponds near the interpretative center site. These projects would require additional investment by the IRRRB.

The hotel feasibility study assumed that the interpretative center and Giants Ridge developments would be successful. The study's authors did not attempt to determine if these developments would increase attendance at the interpretative center as much as the IRRRB estimates because they were not asked to do a market analysis of the drawing power of the expanded center and the new ski facility. Since we question whether the interpretative center expansion will be as successful as predicted, we also wonder whether additional public spending to support a hotel development is a wise investment.

3. RECOMMENDATIONS

We recommend that:

- The IRRRB should halt plans to construct the science museum, the historic village and railroad, and the golf course and other amenities for the proposed hotel development. An independent consulting firm that is experienced in market analysis should be hired to analyze the tourism potential of the interpretative center expansion. The consultant should compare the capital and operating costs of the expansion to the estimated benefits from additional tourism.

- The consultant should focus first on the railroad. It is necessary to review whether the railroad without other planned development can generate sufficient benefits to justify its capital and operating costs since a decision must be made soon in order to avoid digging up the center's grounds a second time.

- No additional development should occur unless the expected benfits (including additional tourism revenues for the Iron Range area and operating revenues for the interpretative center) less the additional operating costs are sufficient to pay back the capital costs of development over a reasonable period of time.

- The choice of a consulting firm should be approved by a non-partisan panel of state officials and citizens. For example, IRRRB management could convene a panel consisting of university experts in tourism promotion, the director of the Minnesota Office of Tourism, the director of the Minnesota Historical Society, the Legislative Auditor, and others.

IRRRB management has indicated to us that they do not believe it is necessary for additional development to generate benefits sufficient to pay back its capital costs. They claim that development is justified if it reduces the interpretative center's operating deficit. We believe that a project should not be undertaken unless: 1) its net annual benefits are sufficient to pay back its capital costs over a reasonable period of time, and 2) other economic development projects have less favorable rates of return. For example, if a $10 million project would generate only $500,000 in annual net benefits, it should not be undertaken. The project would take more than 20 years to pay for itself, when the value of benefits received over time are properly discounted.

Even if the consulting firm determines that the proposed expansion or parts of it are worthwhile, we believe that it would be better to wait until after the center's 1986 summer season before going ahead with additional expansion other than the railroad. At that time, IRRRB management would be in a better position to judge the desirability of additional expansion. The amphitheater would have been operating for one summer season and attendance figures for that season would be available.

Even without any additional expansion, we believe that IRRRB management can make more effective use of the existing facility and its new amphitheater. In particular, we recommend that:

- The IRRRB should continue to expand successful events such as ethnic days and attract other potentially successful events such as the polkafest. The new outdoor amphitheater should help in attracting other events.

- The IRRRB should raise admission prices, particularly during special events featuring live entertainment.

In addition, IRRRB management should, when the center reopens, conduct a systematic survey of its visitors. Survey data would help management determine which special events are drawing tourists to the Iron Range and enable management to make informed decisions about the relative benefits of various events.

It should also be noted that the IRRRB is undertaking similar development of interpretative facilities elsewhere on the Iron Range. The IRRRB is spending a total of approximately $350,000 during FY 1984 and FY 1985 for development at the Hill-Annex Mine in Calumet and is considering the construction of an interpretative center at the Croft Mine. The IRRRB has applied for a federal grant to fund 75 percent of the estimated $1.5 million cost of constructing an interpretative center at the site of the Croft Mine. This center would focus on the history of the Cuyuna range.

Our concerns about the desirability of the expansion of the Iron Range Interpretative Center also apply to these two projects. Without the federal grant, the Croft Mine project would be a very questionable expenditure of funds. Even with the federal grant, we wonder whether the center would generate enough interest to justify its costs. Before any more interpretative centers or similar developments are funded, IRRRB should have an independent consulting firm thoroughly review the benefits and costs.

B. GIANTS RIDGE SKI FACILITY

1. BACKGROUND

The Giants Ridge ski area is on the Iron Range near Biwabik, Minnesota. The ski area was privately operated for over 20 years until it closed in 1982 due to financial problems. It could not effectively compete with other ski areas in northern Minnesota because of its poor ski facilities. It did not have a chair lift system. Also, its snow making system did not work and its base facilities were in bad condition.

In 1983, the IRRRB purchased the ski area and is investing $6.9 million to redevelop the ski area. To improve the conditions for alpine skiing, the IRRRB realigned existing ski runs, created new ski runs, added two new chair lifts, and installed new snow making equipment. It also created a 40 kilometer groomed cross country trail system. The alpine ski area and three kilometers of the cross country ski trail will be lighted for night skiing. There will also be an open field stadium area for starting and finishing cross country ski races. The IRRRB also constructed a maintenance building and a chalet building which includes a dining area, lounge, and ski equipment rental area. Giants Ridge opened for skiing during the 1984 Thanksgiving weekend.

Giants Ridge is designed to be a training facility as well as a recreational ski area. The United States Ski Association designated Giants Ridge as an Olympic training center for nordic ski events. Giants Ridge will also be a training center for biathlon athletes. To accommodate the training needs of the athletes, the IRRRB is constructing a dormitory style lodging and training facility which can house 50 athletes.

The IRRRB is also considering plans to make Giants Ridge a year-round facility. It is seeking accreditation as an Olympic training site for a variety of summer sports in addition to developing summer recreational facilities. Possible future developments include additional lodging facilities and a field house for sports such as hockey, ice skating, basketball, volleyball, boxing, and wrestling. The IRRRB is also negotiating with Erie Mining Company to acquire land around the two lakes near the ski area. It expects to receive some land by donation (Erie previously agreed to donate some land to the former Giants Ridge owner).

The IRRRB is also applying for federal and state grants to help finance further development of the site. It applied for a $600,000 grant from the United States Economic Development Administration to build six tennis courts, pave the parking lot and service roads, landscape the area, and construct a cross country timing/waxing/washroom building. The IRRRB will provide

$200,000 for these projects--which is included in the $6.9 million budget that the IRRRB has already approved for Giants Ridge. The town of White (the town containing Giants Ridge) applied for a $57,000 matching grant from the Legislative Commission on Minnesota Resources to finance a boat launch facility, parking area, and a foot bridge across the narrows between the two lakes at the base of the ski area. If this application is approved, the IRRRB would provide the $57,000 local match.

As of February 17, 1985, Giants Ridge attracted 24,755 ski visits. This does not include ski visits by about 300 season ticket holders. Preliminary cost and revenue figures indicate that Giants Ridge will probably not meet its operating expenses during its first ski season. IRRRB projects that it will cost about $403,000 to operate the ski facility during the first ski season. In addition, it has a $90,000 advertising budget for Giants Ridge. Thus, total expenses will be about $493,000. As of February 17, 1985, ski visits generated revenues of $214,000. Other operating revenues for Giants Ridge include annual commissions of $40,000 from private operators of the bar, restaurant, and ski shop. Thus, total operating revenues for the ski season will probably be between $300,000 and $400,000. While Giants Ridge will probably have an operating deficit in its first ski season, Giants Ridge management believes they may be able to eliminate operating deficits in the near future if attendance increases. Furthermore, management expects to reduce operating costs in future years since the first year includes some one-time expenses.

2. ANALYSIS

The IRRRB's $6.9 million development of Giants Ridge ski area is primarily designed to promote the economic development of the Iron Range area. The ski facility's economic return can be measured by comparing the capital and operating costs with operating revenues and spending by tourists attracted to the ski facility. Since the Giants Ridge ski facility is a tourist destination, most spending by tourists who ski at Giants Ridge would be an economic stimulant to the area. However, from a regional or state perspective, one needs to consider competition with other ski facilities. Four other large ski facilities in northern Minnesota and one in Wisconsin depend on the same major markets for skiers--particularly the Twin Cities market. Sugar Hills and Quadna are in the Grand Rapids area, Lutsen is on the North Shore of Lake Superior, and Spirit Mountain is in the Duluth area. In fact, Sugar Hills and Lutsen are located within the Taconite tax relief area. The other two facilities are just outside this area. A significant proportion of Giants Ridge skiers could come at the expense of these other facilities in northeastern Minnesota.

As a result, it was important that IRRRB management carefully consider the market for the Giants Ridge ski facility and its potential for attracting additional tourists to Minnesota, and northeast Minnesota in particular, before proceeding with a $6.9 million investment. However, we found that:

- IRRRB management did not adequately evaluate the benefits and costs of its $6.9 million investment in the Giants Ridge ski facility.

Before the IRRRB decided to redevelop the ski area, IRRRB management hired a consultant to analyze the operating expenses and revenues of the proposed ski facility. Operation of training and summer recreational facilities was not included in the analysis. The consultant estimated that Giants Ridge's operating expenses would be approximately $628,000 during the first year and $570,000 in each of the following two years. It found that the number of skier days required to provide a breakeven level of operating revenues would be 54,000 in the first year and 49,000 in the following two years. The consultant concluded that achieving this level appears to be reasonable provided that Giants Ridge is adequately promoted, that nearby lodging and entertainment facilities are adequately developed, and that Giants Ridge continues to improve its capital facilities to remain competitive with other ski facilities in Minnesota and Wisconsin.

However, the consultant study was a limited one. The consultant's estimate of skier days was based on comparisons with other major ski facilities in northern Minnesota and Wisconsin which attract between 20,000 and 96,000 skier days per year. According to the consultant's study, ski operators have observed that lodging and entertainment facilities and other amenities have now become important factors in determining where skiers vacation. Giants Ridge has a large promotion budget (currently $90,000 for FY 1985) and has high quality ski facilities in a scenic area. However, it lacks the lodging facilities and entertainment opportunities that other ski areas in northern Minnesota and Wisconsin already have. The closest full service lodging facility is the Holiday Inn in Eveleth, almost 15 miles from the ski area. Biwabik is only four miles from the ski area but currently has few lodging facilities. Other ski areas have quality lodging accommodations and other amenities close to the ski area. The consultant did not analyze how many skiers would come to the facility under existing conditions, nor how long it would take to achieve the 50,000 level.

Examining operating costs and revenues is important, but it is not sufficient to determine whether Giants Ridge is a good investment. Supporters of the development claim that Giants Ridge will create jobs at the ski facility and generate spending and additional jobs in the nearby communities. However, neither the consultant nor IRRRB management analyzed where skiers would come from or how much they would spend in the area. This is necessary in order to compare the major costs (including capital and operating costs) with the major benefits (including operating revenues and tourist spending). Furthermore, neither the consultant nor IRRRB management analyzed how many skiers would come with existing lodging facilities and amenities or how long it would take for private developers to build adequate lodging and entertainment facilities. Finally, no one attempted to estimate the impact of Giants Ridge on other ski facilities, particularly those in northeast Minnesota.

Even if the ski facility does not operate at a deficit, it is not clear that the facility would generate enough benefits to justify its costs. For example, if 20,000 skier visits (counting each day a person skis as one visit) would come from outside the Iron Range area, and these skiers would spend $30 per day in the Iron Range area, the ski facility would bring at most $600,000 per year into the area economy. However, that figure would have to be adjusted downward to the extent that skiers are attracted to Giants Ridge at the expense of other ski areas in northeast Minnesota. Whether the facility is worth its costs depends, in large part, on the extent to which it attracts athletes who are training, competitive skiing events, and tourists who attend those events. If the facility attracts a significant amount of such activity that would not have occurred in Minnesota at other ski facilities, it may result in a large enough injection of spending in the area economy by outsiders to justify the $6.9 million capital cost and potential operating deficits.

IRRRB staff believe that Giants Ridge will not significantly hurt other ski facilities in northern Minnesota for several reasons. First, staff believe the Olympic designation and publicity will enhance the image of northern Minnesota as a ski area and bring additional skiers to northern Minnesota. Second, rates at Giants Ridge will be similar to the rates charged at other ski facilities. Third, skiers want variety in skiing. Giants Ridge adds variety to northern Minnesota skiing and thus may increase skiing visits to northern Minnesota. Finally, IRRRB staff are attempting to work with other northern ski facilities to cooperatively promote skiing in northern Minnesota.

While the skier visits to northern Minnesota may increase, the ski areas in northern Minnesota will still be competing with each other in the same markets. A market analysis of the supply and demand for skiing in northeastern Minnesota would have helped determine how much the Giants Ridge development would affect other ski facilities in northeastern Minnesota. We believe that such an analysis should have been conducted because of the large cost of this project.

IRRRB management is exploring various ways to make the Giants Ridge area a major summer attraction. For example, it had been seeking to make Giants Ridge an Olympic training center for the upper midwest area. If successful, IRRRB would have built lodging facilities for up to 400 athletes and a fieldhouse. Fees would have been charged to cover operating expenses. IRRRB staff claimed that building such a facility could attract about eight million dollars per year into the area's economy based on the experience of a similar facility at Colorado Springs.

However, the University of Michigan at Marquette was recently accredited as an Olympic training site by the United States Olympic Committee. Unlike other facilities, Michigan apparently will provide its facilities at no charge. As a result, IRRRB management says it will not attempt to become a full Olympic training center. Instead, the IRRRB may pursue other training options.

3. RECOMMENDATION

We conclude that IRRRB management should have conducted a more thorough analysis of the estimated benefits and costs of the Giants Ridge ski facility before it was constructed. It is not clear at this time whether the facility will prove to have been a wise risk for the IRRRB to take. The answer depends a great deal on the degree to which the IRRRB can attract training athletes and major ski competitions that would not have otherwise occurred in Minnesota. Given that the ski facility and winter training facilities have been built, the best course of action is for IRRRB management to attract more winter athletes and major events that will draw tourists who would not have otherwise come to northeast Minnesota.

However, any major new construction, particularly that being considered for summer training and recreational activities, should be carefully reviewed before being undertaken. We recommend that:

- Before the IRRRB proceeds with any additional major development at Giants Ridge, the IRRRB should hire an experienced, independent consulting firm to thoroughly analyze the economic return on each major component of any expansion plans. The firm should consider both the capital and operating costs as well as the operating revenues and spending in nearby communities. Furthermore, it should consider whether any new facility would compete with other facilities in the region and state.

C. TOURISM FACILITY LOANS

The IRRRB's bank participation loan program is designed to stimulate economic expansion and diversification in northeastern Minnesota by providing low interest loans to eligible businesses. One business category targeted by IRRRB's loan program is resorts and tourism projects which attract tourism expenditures from outside the region. Under this bank participation loan program, the bank's portion of the loan must equal or exceed the IRRRB's portion. The interest rate is 8 percent on the IRRRB's portion and market rate on the bank's portion of the loan. As of September 1984, the IRRRB had approved 16 tourism loans totaling $1.5 million.

1. RATIONALE FOR TOURISM LOANS

Advocates of tourism loan programs argue that tourism can be increased by expanding and improving lodging and support facilities. Improvements can include a general upgrade of the existing facilities, adding amenities, or making the resort suitable for winter tourism. Loan program advocates reason that tourists are demanding more high quality facilities and that the private sector is not adequately responding to the demand for two reasons. First, many resorts have difficulty raising capital to make improvements that are financially sound. Resort owners often do not have sufficient income to substantially improve their facilities through reinvestment. They often purchased the resort under a contract for deed and consequently find it difficult to offer the bank adequate collateral on a loan. Second, it is claimed that public subsidy is necessary to make marginal projects feasible and that the public benefits of these projects justify the public subsidy.

Evidence supporting these arguments consists primarily of testimonial evidence by people familiar with tourism in the state. There is some empirical evidence that the resort industry is declining in Minnesota.

According to Department of Revenue data summarized by the Minnesota Office of Tourism, the number of resorts in Minnesota has been declining during the last ten years. Also, lodging receipts in northern Minnesota grew at a slower rate than inflation during the last ten years. Possible causes for this decline include the quality of lodging facilities and changes in vacation preferences. Many persons in the tourism industry believe that the quality of the lodging facilities is a major factor. However, it is difficult to measure how much each of these factors has influenced vacation travel in Minnesota.

Determining the validity of these arguments for tourism loans is beyond the scope of this report. Nevertheless, we have several concerns with tourism loan programs which we believe should be considered. The need for publicly subsidized tourism loans depends on:

- Whether many previous tourists are staying away from Minnesota because they were dissatisfied with the quality of their lodging facilities.

- Whether many additional tourists would come to Minnesota if more high quality tourism facilities were available.

- The extent to which publicly subsidized loans displace private investment in lodging facilities.

There is some evidence that few recent tourists to Minnesota were dissatisfied with their lodging facilities.

- The Minnesota Office of Tourism conducted a follow-up survey of persons who requested brochures during its 1984 spring-summer advertising campaign. It found that among persons who stayed at Minnesota resorts, 49 percent rated their accomodations very satisfactory, 48 percent rated them satisfactory, and 3 percent rated them unsatisfactory. Similar ratings were obtained for campground and motel/hotel accomodations. In each accomodation category, only two percent rated their accomodations unsatisfactory.

- A study of tourists on the North Shore in 1981 found that three percent were dissatisfied with lodging accomodations and 47 percent were satisfied. Four percent were dissatisfied with campground accomodations and 34 percent were satisfied. The percentages do not add to 100 because not all tourists surveyed used lodging or campground facilities.[5]

Interpreting these results is difficult because the questions did not ask whether the vacationers would be more likely to return to Minnesota if the lodging facilities had been higher in quality.

Thus, there is little empirical evidence on whether many additional tourists could be attracted to Minnesota if more high quality facilities were available. Furthermore, there is little empirical evidence on the extent to which publicly subsidized loans displace private investment in tourism facilities. But there are reasons to be concerned about this displacement effect:

- Because of the demand for more high quality tourism facilities, many resort owners have already renovated and expanded their facilities and developers have built new facilities without public subsidy. Subsidized loan programs can increase how fast resorts expand but much of the gain may be temporary. Accelerated expansion may reduce the gap between supply and demand and consequently the incentive for future private investment in tourism facilities may diminish.

- Loan programs may subsidize projects that would have proceeded without the subsidy and thus may not have any effect on tourism development. The low interest loans offered by the IRRRB have probably attracted some applicants whose projects would have occurred without public subsidy.

Finally, before determining whether to fund a loan program, it is important to consider alternative ways of achieving the same objective. Education and technical information services may be a less expensive way to expand tourism facilities. Many resort owners lack experience in management and may not recognize opportunities to expand or upgrade their facilities. Currently, the University of Minnesota's Agricultural Extension Service has only one person providing education and information services to tourism businesses across the state.

2. REVIEW OF IRRRB LOANS

IRRRB loans have been used to finance a variety of tourism projects including new lodges, expansion or renovation of existing resorts, recreation facilities and other amenities, campground development, restaurants, and canoe outfitting businesses. The loans approved by the IRRRB as of September 1984 are summarized in Table 13.2. Most of these projects will probably attract tourists from outside northeast Minnesota. The net increase in tourists caused by these projects is difficult to assess because some of the new tourism business may come at the expense of other lodging facilities in northeastern Minnesota. Similarly, net job creation is difficult to measure because it depends on the net increase in tourism. In general, tourism jobs tend to be low paying jobs although the increases in tourist spending helps community businesses.

Nevertheless, our review of IRRRB loan files revealed several problems which limit the effectiveness of the loan program. These include:

- Some projects may have taken place without public subsidy.
- Some projects may have received more subsidy than was necessary to make the project feasible.
- Only a portion of some loans was used to finance development of tourism projects. For example, some loans have been used primarily to refinance existing loans.

In general, these factors are not considered during the loan review process, although in early 1984 the IRRRB adopted guidelines that somewhat restrict the use of loan proceeds for refinancing.

3. NEED FOR SUBSIDY

Under the IRRRB's loan program, the 8 percent interest rate is low enough to attract businesses which do not need a subsidy to expand as well as those which do need a subsidy. However, the IRRRB does not attempt to target its loans to those developments which need a subsidy.

The loan program's guidelines do not address this issue. In fact, the program's financial guidelines are concerned only with the security of the loan. The requirement that banks participate in the loan and share collateral position with the IRRRB eliminates some resorts with marginal projects from consideration.

In our review of projects rejected by IRRRB staff, we did not find any projects that were rejected because they did not need a subsidy to proceed. The financial analysis by IRRRB staff focuses on whether the proposed project is financially sound and not whether the project could be viable without their program.

Projects financed under this program include some expansions of "premier" resorts in the area. These resorts have successfully expanded in the past, have good collateral, and the current proposal appears to be financially sound--all characteristics of a good bank loan.

Similarly, there is a problem in determining how much subsidy a project needs to be feasible. In one case, the IRRRB approved a loan of $375,000 after a bank agreed to loan $761,000. Subsequently, the developer received an additional $200,000 in subsidized financing from the Small Cities Community Development Program. As a result, the bank's participation was reduced by $200,000. The fact that the bank was previously willing to loan an additional $200,000 indicates that the developer may have received more public subsidy than necessary to carry out the project. IRRRB staff knew that the developer was applying for additional subsidies but did not consider that in its loan review.

4. USE OF LOAN PROCEEDS

Nearly one-half of the tourism loans approved by the IRRRB as of September 1984 did not use all of the loan funds for actual development because they included some refinancing of existing debt. Loan dollars used for refinancing amounted to nearly 22 percent of IRRRB tourism loan dollars. Two early applications approved under the IRRRB loan program were almost entirely refinancing of existing debt with very little or no new development tied to the project. One $125,000 loan made by the IRRRB was used entirely for refinancing. On its application, the loan recipient claimed that it could expand its business, build a lodging facility for its outfitting customers, and create new jobs. But these are only plans, with no evidence of financial commitment to the plans. Under the refinancing arrangement with the IRRRB, the company has no obligation to follow through with its plans.

The second project included $148,000 for refinancing, $1,656 for operating expenses, and only $5,344 for new construction and equipment. The IRRRB and the bank each financed $75,000 of the project and the business contributed $5,000. Again, there was no written commitment to make other improvements in the future.

The IRRRB has approved five other projects which combine refinancing with development. The amount of refinancing in these projects has ranged from $9,000 to $140,000.

The IRRRB received many of these applications before it developed its loan program guidelines. These policy guidelines now state that "no projects which are entirely or primarily a refinancing of existing debt will be allowed unless such refinancing will result in a significant upgrading of facilities or expansion of operations." Subsequently, the IRRRB has rejected all projects which are entirely refinancing proposals. However, some refinancing is still allowable under these guidelines.

The problem with this practice is that the IRRRB may not be getting the highest return for its investment. Even if a refinancing proposal includes additional development which will increase tourism, the IRRRB may be able to fund more future development with the same amount of money if they do not fund the refinancing portion of the project. The rationale for refinancing is that the owner will not be able to carry out the project without the refinancing. However, this does not always seem to be the case. For example, one proposal included refinancing even though the owner has substantial personal wealth.

A problem similar to refinancing may occur when loan proceeds are used to purchase existing property. One project received a $112,000 loan to develop a campground. The loan included $50,000 to refinance an existing loan, $40,000 to purchase undeveloped shoreline property adjacent to the applicant's marina, but only $22,000 to develop the campground and other facilities. The problem with allowing loan proceeds to be used for property purchases is that it may not be a cost effective way to finance a campground development. One reason that this practice may not be cost effective is that other campground developments may be proposed which do not require financing for property purchases. Another reason is that it may be difficult to determine whether subsidizing property purchases is necessary for the project to occur. As a result, the IRRRB may provide more subsidy than is necessary to finance the development. Originally this loan application asked for a loan of $269,500.

This was cut back by reducing the amount of refinancing and eliminating working capital. While this is an improvement over the original application, still only 20 percent of the loan amount is being used for new development.

5. RECOMMENDATIONS

To avoid giving more subsidy than is necessary to induce development, we recommend:

- IRRRB staff should revise its approach to loan review. In addition to examining the financial stability of a project, staff should also consider whether the project could proceed without a loan subsidy and, if practical, how much subsidy is needed.

To avoid inappropriate use of loan proceeds for refinancing or property purchases, we recommend that IRRRB revise the loan program's guidelines. Specifically,

- We recommend that the IRRRB adopt a guideline which limits the IRRRB loan amount to 50 percent of the cost of new development. This guideline could be made flexible enough to allow refinancing or property purchases if IRRRB staff and the board determine that the project has enough benefits to justify the additional subsidy and that the extra subsidy is necessary to induce development.

As we pointed out in Chapter 13, IRRRB management agrees that bank participation loans may not be the best way to stimulate economic growth. IRRRB management thinks tourism loans should be extended to resort owners who cannot get bank financing because their resorts were originally purchased on a contract for deed. We believe that this idea may have some merit but should only be done on a limited basis because of the riskiness of the projects and the limited staff resources now available.

D. PAULUCCI PLANETARIUM

The Paulucci Planetarium, located at Hibbing Community College, features a planetarium theatre and a telescope for public and school use. It has both educational and tourism objectives although the current IRRRB management now considers the planetarium's role to be primarily educational.

The Planetarium Theatre is a small scale version of the Science Museum's Omnitheatre in St. Paul without a hemispheric projection system. Currently, the theatre has a star projector, a multi-image slide projection system, a special effects projection system, and an eight-channel sound system.

The planetarium offers several programs on astronomy, space exploration, and the environment to the public. The community college and the community education system both hold regular classes at the planetarium. The planetarium also offers special programs for elementary and secondary school students. The IRRRB plans to purchase a $75,000 hemispheric projection system for the planetarium during FY 1985. Planetarium staff believe this will double attendance.

1. ANALYSIS OF EXISTING PLANETARIUM OPERATIONS

The planetarium's operating expenses for FY 1984 were about $72,000. Its admission and merchandise revenues were about $14,000, resulting in an operating loss of $57,000. These operating costs do not include the cost of custodial services and student workers paid by Hibbing Community College. Excluding the cost of the new projection system, the planetarium's fiscal year 1985 budget is approximately $132,000. This includes the cost of student workers, and custodial services that were not included in the previous year's budget. If the planetarium's income remains at about $14,000 per year, the operating deficit would be $118,000.

As a tourist attraction, the planetarium has not been successful. During the fiscal year ending June 30, 1984, approximately 16,288 persons visited the planetarium. Paid admissions were 8,240. The 8,048 unpaid admissions included 1,274 college students and 5,426 pre-college students who attended specially arranged programs. While paid attendance declined by over 3,000 from the previous year, school attendance increased by over 3,000.

The planetarium's guest registration data indicates that in academic year 1983-84, 55 percent of regular paid admissions were from the Iron Range area, 26 percent were from other parts of Minnesota, and 19 percent were from other states. Only four percent were from the Twin Cities metropolitan area and two percent were from Duluth. While guest registration data is usually suspect, the planetarium's data appears to be fairly reliable because of unusually large response rates. Forty-seven percent of regular show visitors registered in 1980-81. The geographic distribution of persons registering in 1980-81 is similar to the results reported above (in 1983-84 the response rate was 22 percent).

The attendance data alone suggests that the planetarium does not have substantial economic development benefits. It is difficult to precisely measure the economic impact of the planetarium because IRRRB management and planetarium staff do not have information on why planetarium visitors come to the Iron Range area nor on how much they spent. However, even if one-fourth of the estimated 3,700 visitors from outside the Iron Range area came to the range because of the planetarium, and if they spent $20 per person in the range area, the total tourist spending generated by the planetarium would be only $18,500. This is substantially less than the planetarium's operating deficit. We doubt that even 10 percent of the planetarium's visitors from outside the range come to the Iron Range specifically because of the planetarium.

2. FUTURE DEVELOPMENT OF THE PAULUCCI PLANETARIUM

In order to strengthen its programs, the planetarium staff have requested a $75,000 hemispheric projection system for FY 1985, a $80,000 laser light show system for FY 1986, and a $85,000 wide-screen video system for FY 1987. In addition, staff requested funding for a full-time clerk, an audio-visual technician, and a half-time education coordinator over the next two years. The IRRRB has approved the hemispheric projection system, but plans no other major equipment purchases or capital improvements without further study.

Planetarium staff project that the hemispheric projection system and the IRRRB's increased advertising budget will double its attendance to 32,000. Staff also estimate that a laser show would increase attendance by an additional 33 percent in 1986, and a wide screen video show would increase attendance by an additional 25 percent in 1987. Even these projected attendance increases would not reduce the planetarium's operating deficit because of necessary staff increases and low admission charges (currently students do not pay for admission and the average paid admission charge is only $1.05 per person). The increase in attendance could potentially, however, favorably affect tourism expenditures in the Iron Range area.

However, we doubt that the planetarium, even with all these improvements could substantially increase paid attendance by tourists. Planetarium staff base their attendance projections on the percentage increases that occurred at Triton College (located a few miles from Chicago) when similar improvements were made. It is not reasonable to expect a planetarium located in Hibbing to be able to expand its attendance as much as one that was able to draw on one of the largest metropolitan markets in the nation.

3. RECOMMENDATIONS

We recommend that:

- The IRRRB should not provide any additional funding to the planetarium for new equipment or capital improvements in the near future.

The IRRRB should not consider additional improvements at the planetarium unless the hemispheric projection system has a significant impact on tourist attendance figures. If the hemispheric projection is not successful in increasing paid attendance from outside the Iron Range area, we doubt that laser shows or the wide-screen video system would be successful. In addition, additional purchases should not be approved unless it can be documented that the planetarium is a key element in drawing tourists to the range or in influencing them to make return visits.

E. TOURISM PROMOTION

Tourism promotion is another strategy used by the IRRRB to increase tourism to the Iron Range area. The IRRRB's advertising budget grew from about $154,000 in FY 1984 to about $290,000 in FY 1985. Advertising for the Giants Ridge ski area is responsible for $90,000 of this increase. IRRRB management plans to coordinate the promotions of attractions on the Iron Range during 1985. Previously, attractions such as the interpretative center, the Paulucci Planetarium, and mine tours each conducted its own advertising campaigns independently.

The rationale for cooperative tourism promotion of the Iron Range area is supported by research at the University of Minnesota. Researchers at the University of Minnesota found that tourism promotion may be effective if it includes cooperative promotion by public and private tourism organizations in a destination area.[6] Examples of vacation destination areas in northeastern Minnesota include the boundary waters area, the north shore, the Lake Vermilion area, and the Iron Range area. Advertising is usually more effective if it features a variety of attractions in an area. Advertising by individual organizations often focus on their own attraction without recognizing that tourists look for a package of activities or attractions when selecting a vacation destination. Another advantage of cooperative advertising is that it can use higher quality advertising that individual businesses could not afford on their own. It also avoids duplicative advertising by businesses selling essentially the same product.

University of Minnesota researchers found that the cooperative promotion campaign for the Lake Vermilion area generated about $7.67 in tourist spending per dollar invested during the first year. Preliminary results for the second year suggest that the return for the campaign's second year suggest that the return will be higher than it was during the first year. To measure the effectiveness of this promotion, resorts recorded what prompted their guests to come to Lake Vermilion.

These results suggest that the IRRRB's plans to coordinate the promotions of attractions on the Iron Range are likely to improve the effectiveness of its advertising. Another improvement IRRRB management plans to make for 1985 is to include the phone number or address of the Anchor Lake Tourist Information Center on more of its advertisements. This will enable tourists to obtain additional information to help plan their vacations.

However, simply coordinating its advertising does not guarantee that promotional efforts will be effective for the Iron Range area. Not all marketing programs developed by the University in northeastern Minnesota were as effective as the Lake Vermilion program. It is important to measure the effectiveness of any promotional program so that future adjustments can be made based on the relative effectiveness of various advertisements and promotional techniques. However, the IRRRB has no plans to monitor the effectiveness of individual advertisements. We recommend:

- IRRRB management should establish a monitoring system to track inquiries for each advertisement. This will help the IRRRB avoid advertising in unproductive markets. IRRRB management should also either survey a sample of persons who make inquiries, like the Minnesota Office of Tourism does, or survey Iron Range area tourists to determine the effectiveness of its advertisements.

F. CAMPGROUND AND RECREATIONAL FACILITIES

Under the mineland reclamation program, the IRRRB has developed campgrounds or recreational facilities near seven abandoned mine pits since 1979. All seven of the projects were operational last summer. The IRRRB has approved an eighth project scheduled to begin construction in 1985. The IRRRB has invested a total of $820,000 in these projects, including funds committed for development during 1985. Cities are responsible for operating and maintaining these facilities. Typically, these projects include a boat landing and, if necessary, public access to the lake at the bottom of the mine pit. Some projects included campground facilities, parking areas, or picnic areas. In addition, the IRRRB is spending $49,000 to stock game fish in the lakes on some abandoned mine pits. The largest development is the West Two Rivers development near Mt. Iron. It includes a campground, a swimming beach and changing house, a boat landing, and a ball field.

The IRRRB's attempts to increase tourism in this way appears to be reasonable. Fishing is a major tourist attraction in northern Minnesota. It makes sense to spend moderate amounts of money to test the potential of this market. Furthermore, an

IRRRB consultant found that there was a shortage of campgrounds on the Iron Range and as a result, existing campgrounds were often overcrowded. These additional campground developments should help alleviate this problem.

Now is a good time to assess how well these facilities attract tourists to the Iron Range area. There are other abandoned mine sites which could also be developed into campground and recreational facilities. To determine whether additional developments are worthwhile, the demand for these facilities should be carefully monitored and their tourism impact assessed. Mineland reclamation management has not yet analyzed the economic benefits of these developments. Accordingly, we recommend:

- IRRRB management should monitor the usage of these recently developed facilities and determine if further development would bring a sufficient number of additional tourists to the Iron Range to justify its costs.

NOTES

[1]We believe it is likely that tourists stayed in the Iron Range area longer during ethnic days and the polkafest than during other times of the year. Consequently, we assumed that spending per person was larger during those events.

[2]The 130,000 attendance is based on the attendance between August 1, 1983 and July 31, 1984. This is the highest attendance for any 12 month period. While this attendance is higher than the 120,000 figure we reported for the year ending August 31, 1984, the paid admissions for these two time periods are very close. The difference appears to be the result of a much higher count of repeat visits (persons who visit the center more than once on the same day are counted more than once) in August 1983 than August 1984.

[3]The DBS Consultancy, "A Preliminary Feasibility and Cost Study for the Construction and Operation of an Excursion Railroad for the Iron Range Interpretative Center," August 1984, p. 12.

[4]Laventhol & Horwath, CPA, "Market Study and Financial Projections for Proposed Iron Range Interpretative Center Hotel, Chisholm, Minnesota," November 1984, p.II-10.

[5]Knopp, Timothy and Vel Blank, "The North Shore Experience," Research Report No. 8, Minnesota Sea Grant Institute, 1983, St. Paul, MN, p. 38.

[6]For example, see Ballman, Gary, Tourism as an Economic Stimulus in Northeast Minnesota, University of Minnesota, April 1984.

A. BACKGROUND

The boiler conversion program encourages school districts and other public organizations to convert their buildings' heating systems to burn wood, peat, or both. Initially, this program provided funds in a half grant, half interest-free loan package. In June 1983, the IRRRB revised the program so that boiler conversion funds are provided entirely through interest-free loans. Under these new guidelines, public agencies were allowed a one year grace period before repayment begins, thus allowing the loan to be repaid out of accumulated savings. IRRRB staff estimate that the average payback period for the boiler conversions has been 4.2 years, with paybacks ranging from two to 10 years. The IRRRB has approved approximately $4.9 million in boiler conversion projects.

Since most Iron Range school districts have now converted their heating systems through the boiler conversion program, IRRRB management is considering extending the program to private businesses. According to management, a program for private businesses would probably be structured like the bank participation loan program. A business would be charged at least eight percent interest and the IRRRB's funding would be limited to half of the project cost.

The IRRRB-administered research project at Wilderness Valley Farms, begun in 1983, is designed to determine the feasibility of peat production from a prepared peat bog. Research staff are documenting the costs of production, the temperature and rainfall during harvest months, and the amount of usable peat collected. This information, along with heat content data from the Department of Natural Resources' test burns of peat in boilers, will be used by the IRRRB to promote peat production and use. Since much of the first year of operation was spent preparing the site, the best data will be available from the 1984 harvest. IRRRB funding for this project was approximately $850,000.

The second phase of the peat demonstration project is to document the costs of peat production from an unprepared site. The IRRRB has contracted with a private peat producer from Sweden, Rasjo Torv, to conduct this project. In addition to documenting the costs associated with peat production from a virgin bog, the company is to develop markets for Minnesota peat and perhaps eventually locate in Minnesota should the project prove feasible. To induce the company to undertake this project, the IRRRB provided funding through the NEPF. This was arranged by transferring $1 million initially set aside for IRRRB research at Wilderness Valley Farms to the Swedish project. The Minnesota Department of Natural Resources reimbursed the IRRRB for $250,000 of the costs of the project, making the IRRRB's net cost $750,000.

Alternative Energy Development

Chapter 15

The IRRRB's decision to target the alternative energy sector is based on the rationale that energy producing firms will reduce Minnesota's reliance on energy imports, thus decreasing the outflow of energy dollars from the state. These dollars will then circulate within Minnesota for longer periods of time and stimulate economic activity. Further, IRRRB staff argue that conventional lenders are reluctant to support alternative energy projects because of a mistaken belief that they pose high risks. Consequently, development of the alternative energy industry will require public intervention. The IRRRB is not the only proponent of these views. A number of DEED programs are based on the same rationale and the Legislature has required the IRRRB to give priority to alternative energy development.

Since 1983, the IRRRB has committed approximately $7.5 million to major energy projects, including:

- $4.9 million to convert boilers in Iron Range schools and other public buildings to burn peat or wood, fuels found in abundance in northeast Minnesota.
- $1.6 million in research funds for two peat development projects, one conducted by the IRRRB and the other by a private firm.
- Close to $1 million in loans to alternative energy suppliers through the bank participation loan program.

In addition, as we pointed out earlier, the IRRRB spent $1.8 million to construct an energy building at the interpretative center. These projects have been funded through the IRRRB's allocations from the Northeast Minnesota Economic Protection Trust Fund.

In the following sections, we describe the IRRRB's energy development efforts and raise some concerns about their ultimate impact on the economy of northeastern Minnesota.

If this project is successful and the Swedish firm decides to develop peat lands in Minnesota, the $1 million in funding must be repaid with interest. Otherwise, the funds will be considered a research grant and the results of the research will be available for the IRRRB's use in attracting other developers.

A total of eight loans have been made from the NEPF to companies in the alternative energy field. Four of the loans went to three new companies that produce either wood pellets, peat, or both. Two of the loans went to operators of district heating systems. One loan went to a firm that was expanding its operations to include production of a smokeless, wood-fired furnace for home heating. Another loan went to a company that supplies peat for horticultural purposes. These loans were listed in Table 13.2.

IRRRB staff contend that providing alternative energy suppliers with bank participation loans accomplishes two things: it provides low interest rates to marginal projects and it encourages private lenders to participate in loans for energy projects. If lenders have success with these loans, they are likely to view future energy proposals more favorably.

B. DISCUSSION

Like the Department of Energy and Economic Development (DEED), the IRRRB takes a two-pronged approach to energy development. First, by encouraging conversions of heating systems to those that utilize Minnesota's energy resources, demand for energy is affected. Second, by providing financing for energy producers, the supply of alternative energy fuels produced in Minnesota is increased. With the IRRRB's approach, both sides of the market are subsidized: the below market rate financing provided through the bank participation loan program reduces the price of peat and wood products, and the grants and interest-free loans provided through the boiler conversion program improve the attractiveness of conversion to alternative fuel heating systems. In addition to the IRRRB's subsidies, at least half of the energy projects funded through the bank participation loan program received other sources of public financing compared to about one-fifth of the business development projects. For example, in a loan to a wood pellet manufacturer, the IRRRB provided $330,000 at eight percent interest with a private lender providing the balance of the financing. This project also received 80 percent insurance coverage on the $1,500,000 private loan through DEED's energy loan insurance program and an equity contribution through a Michigan assistance program. Another energy project received a $100,000 federal grant. Still another received assistance through a community development corporation. Thus, it appears that significant amounts of public subsidy will be required to successfully develop the alternative energy industry.

Despite the significant amount of public funds committed to the energy industry, no one has conclusively determined the amount of benefit the state can expect to realize from this effort. Economic theory indicates that the state should concentrate on products in which it has a comparative advantage--those that can be produced more cheaply in Minnesota than they can elsewhere--and export those products to other states and nations. Likewise, products produced at lower costs elsewhere should be imported to Minnesota. Some researchers contend that northeast Minnesota does not have a comparative advantage in energy and that public funds should not be expended on peat development.[1] Others, including DEED officials, claim that Minnesota can have a comparative advantage in energy and that keeping energy dollars within the state will generate enough economic growth to justify the level of subsidies provided to the energy industry. Still others are cautiously optimistic. They point out that peatland development will likely provide only a limited number of jobs for northern Minnesota. They state that large scale peatland development has not yet been shown to be economically feasible and that such development will only occur with public subsidies.[2]

In some respects, the IRRRB is proceeding cautiously. For example, its peat research projects are designed to address the question of whether large scale peatland development is economically feasible. The IRRRB is taking a risk by investing $1.6 million in peat research. However, it is a risk that will have been worthwhile if large-scale production proves to be economically competitive with other energy sources.

Boiler conversions financed by the IRRRB have generally had projected payback periods of less than ten years. The average payback period is slightly more than four years. Thus, the conversions to wood pellets or other wood products appear likely to pay for themselves over a relatively short time period.

However, we have a number of concerns about the IRRRB's energy development programs and the direction they may take in the future. First, we believe that IRRRB staff needs to more carefully consider the loans made to alternative energy suppliers. IRRRB staff generally assume that loans to such suppliers are desirable since the law governing the use of the NEPF mentions energy projects as a priority. We believe staff need to better examine the markets that loan applicants intend to serve. We noted two start-up businesses that received loans from the IRRRB identified several of the same consumers as potential customers. Staff need to be careful that loans are not made to too many companies that are all competing for the same limited market. Otherwise, some companies may fail and default on their loans or request additional public subsidies from the IRRRB or other public agencies.

Second, the IRRRB needs to reexamine the formula used to calculate the payback period for energy conversions. The formula used is relatively simple. The payback period (in years) is the cost of conversion divided by the first year's energy savings due to conversion. This formula does not discount the value of savings in future years as should be done. In calculating the benefits and costs of a project, one generally values benefits received in future years less than benefits received in the current year because of the value of money over time. The formula also does not account for expected changes in conventional and alternative fuel prices in the future.

DEED staff say that the formula, though simple, has been a good measure of the payback period. Discounting future cost savings would have lengthened estimated payback periods and made conversion projects less desirable. However, DEED staff say that because conventional fuel prices were rising rapidly in the past, the formula tended to overestimate the payback period. The formula's failure to account for rising conventional fuel prices tends to offset the failure to discount future energy savings.

While this many have been true in the past, we wonder whether this can be expected to be true in the future. The rate of increase in prices of conventional fuels has leveled off in recent years and perhaps can be expected to rise much slower than they did in the 1970s. Consequently, the simple payback formula currently used may understate the payback period and permit some projects to be funded that are not economically beneficial. If the IRRRB makes any additional interest-free loans for conversions by public agencies, the payback formula should be adjusted to discount energy savings received in future years. This issue is not as important for the proposed IRRRB loans to private businesses provided that the IRRRB charges these businesses at least eight percent interest and requires matching bank participation. Similarly, DEED's use of the simple payback formula is less of a concern because DEED loans to municipalities require the payment of interest.

Finally, we believe that the IRRRB will face some key decisions about peatland development once the results of its various research projects are available. Further development, particularly on a large scale, may require public subsidies. The IRRRB and other state agencies will need to carefully examine and compare the benefits of such development to the costs, including the costs of public subsidies and any necessary reclamation after development. Development should not occur unless the expected benefits exceed all the relevant costs. In addition, IRRRB staff should consider what impact, if any, peatland development would have on existing Minnesota suppliers of wood pellets and other wood products used for fuel.

NOTES

[1]Dewar, Margaret, "Development Analysis Confronts Politics: Lessons from Minnesota about the Role of Analysis in State Industrial Policy," in Harvey Goldstein, ed., _The Industrial Policy Debate: State and Local Issues_, forthcoming.

[2]See the task force's summary report, pp. 10-11, and Doug Wilson, _Peatland Development: Slow Growth Ahead_, University of Minnesota, May 1984.

Conclusions

Chapter 16

In general, we find that:

- The IRRRB has identified in its economic development plan appropriate sectors of the economy (tourism, timber and wood products, alternative energy, new mining technologies, and manufacturing and other businesses that diversify the economy) in which opportunities for economic development exist. The areas identified by the IRRRB are similar to those identified by the Northeast Minnesota Task Force at the University of Minnesota.

However:

- The IRRRB has not adequately analyzed the benefits and costs of some of the economic development ventures it has funded. This is particularly true of the IRRRB's expansion of the Iron Range Interpretative Center and its development of the Giants Ridge ski facility. It is true to a lesser extent of IRRRB's business development programs.

- For an agency that is now so involved in economic development, the IRRRB has very few staff with the experience and training necessary to evaluate the potential of proposed development projects.

It is difficult at this point to say just how successful IRRRB-funded projects will be in creating jobs to replace the estimated 10,000 jobs that have been lost on the Iron Range. Some of IRRRB's projects involve research that may stimulate future growth but has little effect at this time. This is true of the plasma-smelt and coal reduction projects, peat research, and wood products industrial park studies. We support the IRRRB's current efforts in each of these areas, although they may not all ultimately create jobs.

The IRRRB's bank participation loan program has helped to create and retain some jobs on the Iron Range, but not as many as the 1,000 jobs that IRRRB management claims it has created and retained. The loan program should be modified. IRRRB staff need to more critically examine whether IRRRB's involvement with particular projects will actually result in job creation or retention. The IRRRB should not provide public subsidies in excess of those needed for a business expansion to be undertaken.

A number of smaller tourism ventures funded by the IRRRB have potential for generating economic activity in excess of their costs. However, the IRRRB's two largest projects--the expansion of the Iron Range Interpretative Center and the development of the Giants Ridge ski facility--may not be successful. We doubt whether an expanded interpretative center operation can draw a sufficient number of additional tourists to justify the capital and additional operating costs. We are somewhat more optimistic about the ski facility, but its success depends on whether IRRRB will be able to attract enough athletes and major sporting events that would not otherwise have come to Minnesota. Moreover, we are concerned about the potential impact of Giants Ridge on other ski areas, particularly those in northeast Minnesota. Further development at this facility, or development of other similar projects, should be carefully examined by an independent consulting firm before the board commits any additional funding.

In the future, we recommend that:

- IRRRB management should focus more of its attention on attracting larger business expansions from businesses outside the Iron Range, particularly businesses outside the state.

The IRRRB was successful in getting a large company to build a waferboard plant near Two Harbors, using industrial revenue bonds to finance plant construction costs and an interest buydown on an equipment loan. This company will employ about 100 workers at the new plant. IRRRB management and the Governor are currently attempting to persuade General Motors to locate a new plant in northeastern Minnesota (Duluth). However, GM is being courted by dozens of states because the plant would employ about 6,000 workers.

We realize that it is difficult to attract businesses from elsewhere. IRRRB's job will not be easy. Northeastern Minnesota's distance from product markets does not work in its favor. However, if a significant number of the 10,000 lost jobs are to be replaced, the IRRRB will need to pursue expansions by larger businesses.

We also recommend that:

- The IRRRB should hire a minimum of two additional staff whose training and experience enable them to evaluate the benefits and costs of proposed development projects.

As we have noted, the IRRRB has remarkably few staff to review potential development projects. Hiring several staff would free some of the business development administrator's time for pursuing larger business expansions. In addition, the new staff can provide IRRRB management and the board with a more effective review of proposed tourism projects and ongoing oversight of its tourism promotion and other existing programs. Currently, management must rely on program staff who may not wish to seriously evaluate their operations or proposed program expansions.

Finally, there is the question of whether ongoing oversight of the IRRRB is needed beyond that provided by the Legislative Advisory Commission and the Governor. In July 1982, when the board first gained access to the NEPF, a trust fund board was created. That board had to approve any spending from the NEPF before the IRRRB could use NEPF monies for economic development projects. In April 1983, the Legislature abolished the trust fund board. Iron Range legislators said that the trust fund board was not needed and that it delayed the process of getting development projects started on the depressed Iron Range.

We believe that greater review of major IRRRB ventures such as the interpretative center expansion and the Giants Ridge development prior to the commitment of funds is desirable. Without any law change, the Legislative Advisory Commission could serve as a vehicle for more effective oversight of IRRRB projects. Currently, all projects funded through either the TEPF or the NEPF must be reviewed by the commission. The commission's recommendation is, however, advisory and final approval is up to the Governor. Nevertheless, the commission could put pressure on the IRRRB to undertake market analyses of major projects as we have recommended in this report.

We have also recommended that the IRRRB expand the Technical Advisory Committee used to review proposed business loans. An expanded committee could also assist IRRRB staff in reviewing other proposed business ventures not involving the loan program.

STUDIES OF THE PROGRAM EVALUATION DIVISION

Final reports and staff papers from the following studies can be obtained from the Program Evaluation Division, 122 Veterans Service Building, Saint Paul, Minnesota 55155, 612/296-4708.

1977

1. Regulation and Control of Human Service Facilities
2. Minnesota Housing Finance Agency
3. Federal Aids Coordination

1978

4. Unemployment Compensation
5. State Board of Investment: Investment Performance
6. Department of Revenue: Assessment/Sales Ratio Studies
7. Department of Personnel

1979

8. State-sponsored Chemical Dependency Programs
9. Minnesota's Agricultural Commodities Promotion Councils
10. Liquor Control
11. Department of Public Service
12. Department of Economic Security, Preliminary Report
13. Nursing Home Rates
14. Department of Personnel, Follow-up Study

1980

15. Board of Electricity
16. Twin Cities Metropolitan Transit Commission
17. Information Services Bureau
18. Department of Economic Security
19. Statewide Bicycle Registration Program
20. State Arts Board: Individual Artists Grants Program

1981

21. Department of Human Rights
22. Hospital Regulation
23. Department of Public Welfare's Regulation of Residential Facilities for the Mentally Ill
24. State Designer Selection Board
25. Corporate Income Tax Processing

26. Computer Support for Tax Processing
27. State-sponsored Chemical Dependency Programs, Follow-up Study
28. Construction Cost Overrun at the Minnesota Correctional Facility - Oak Park Heights
29. Individual Income Tax Processing and Auditing
30. State Office Space Management and Leasing

1982

31. Procurement Set-Asides
32. State Timber Sales
33. *Department of Education Information System
34. State Purchasing
35. Fire Safety in Residential Facilities for Disabled Persons
36. State Mineral Leasing

1983

37. Direct Property Tax Relief Programs
38. *Post-Secondary Vocational Education at Minnesota's Area Vocational-Technical Institutes
39. *Community Residential Programs for Mentally Retarded Persons
40. State Land Acquisition and Disposal
41. The State Land Exchange Program
42. Department of Human Rights: Follow-up Study

1984

43. *Minnesota Braille and Sight-Saving School and Minnesota School for the Deaf
44. The Administration of Minnesota's Medical Assistance Program
45. *Special Education
46. *Sheltered Employment Programs
47. State Human Service Block Grants

1985

48. Energy Assistance and Weatherization
49. Highway Maintenance
50. Metropolitan Council
51. Economic Development Programs
52. Post Secondary Vocational Education: Follow-Up Study (in progress)
53. State Aid Highway and Street Systems (in progress)

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*These reports are also available through the U.S. Department of Education ERIC Clearinghouse.