
MINNESOTA OFFICE OF THE LEGISLATIVE AUDITOR

State Grant and Loan Programs for Businesses

EXECUTIVE SUMMARY

State grant and loan programs for businesses are supposed to create jobs.

The Minnesota Legislature created the Economic Recovery Grant program in 1984 to stimulate economic activity and job creation by providing a source of money for businesses. Administered by the Department of Trade and Economic Development (DTED), the program provides grants, loans, and other financial awards to communities on behalf of particular businesses to help finance costs associated with the businesses' expansion, startup, or relocation. Since 1984, the Legislature has appropriated over \$68 million in state funds and has used over \$35 million in federal funds from a similar program, the Small Cities Community Development Block Grant program.

The Legislative Audit Commission directed our office to study the Economic Recovery Grant program and other programs providing state financial assistance to businesses in the form of grants or loans. We studied the Economic Recovery Grant program and the similar federally-funded Small Cities Community Development Block Grant program (together referred to as the Economic Recovery Fund), as well as the Challenge Grant, Capital Access, and Small Business Development Loan programs. Our study addressed the following questions:

- **What does previous research show about the effectiveness of business financial incentives?**
- **How do Minnesota's economic development tools compare with those used in other states?**
- **Are current grant criteria and proposal review procedures adequate?**
- **What is the track record of the Economic Recovery Grant program, as well as other state economic development programs, in creating and retaining jobs? What are the wage levels of the jobs that are created?**
- **Has the state received repayments from past Economic Recovery loans as required in law? How has the money retained by communities in local revolving loan funds been used?**

To answer these questions, we reviewed the literature on state economic development policies; collected information from economic development officials in neighboring states; interviewed the program administrators and loan officers at the Minnesota Department of Trade and Economic Development; reviewed the files of 176 projects that were funded by the Economic Recovery Grant or Small Cities programs between fiscal years 1991 and 1995; reviewed department records on the Challenge Grant, Capital Access, and Small Business Development Loan programs; interviewed decision makers at businesses that were beneficiaries of state loans or grants; and conducted a survey of local government revolving loan fund administrators.

STATE FINANCIAL INCENTIVES

States have offered incentives to businesses since the earliest days of this country, but the use of incentives has increased markedly over the past 15 years. The literature shows that business executives increasingly expect government assistance when they expand.

Many economists maintain that granting financial incentives to businesses to create jobs is a “zero-sum” game on a national level. In other words, they say that incentives may not actually create jobs, they may just move them from one place to another. Nevertheless, it may be rational for a state to offer financial incentives if it can entice more firms to move into or expand inside its borders rather than in other states or countries. Studies of industrial plant location decisions show that financial incentives from governments play a relatively small part in business decision making, but they can make a difference after other factors have been taken into account.

ECONOMIC RECOVERY GRANT PROGRAM

The Economic Recovery Grant program is the state’s main program for job creation and retention. We examined all grants, loans, and forgivable loans made by the program between 1991 and 1995 and found that the 176 projects assisted during that period created over 8,300 jobs. Manufacturing companies received about 80 percent of the funding and created about 60 percent of the jobs.

Companies generally have two years to create the jobs they promise. Table 1 shows that a high proportion of projects met their job creation goals. Those that did not meet their goals within two years, including nine firms that went out of business during the period, fell short by a total of 1,022 jobs.

We verified companies’ job claims with separate information they report to the Department of Economic Security (DES) and found that the information was consistent. But, sometimes the jobs created were not permanent. For the 112 compa-

A high proportion of businesses receiving assistance met their job creation goals.

Table 1: Economic Recovery Fund, FY 1991-95, Jobs Promised and Created by Project Status

<u>Project Status</u>	<u>Number of Projects</u>	<u>Projects that Met Job Goals⁴</u>	<u>Number of Jobs Promised</u>	<u>Number of Jobs Created</u>	<u>Percent of Jobs Promised</u>
Open < 2 years ¹	50	13	2,101	1,947	93%
Open > 2 years ²	9	4	570	491	86
Closed ³	<u>96</u>	<u>78</u>	<u>5,594</u>	<u>5,898</u>	<u>105</u>
Total	155	95	8,264	8,337	101%

Note: "Economic Recovery Fund" refers to both the state and federal funded programs.

Source: Program Evaluation Division analysis of the Department of Trade and Economic Development reports.

¹Includes all projects originating in FY 1993-95 that have not been completed for which job creation information was provided.

²Includes all projects originating in FY 1991-92 that have not been completed for which job creation information was provided.

³Includes all projects that have been completed for which job creation information was provided.

⁴Includes all projects that met or exceeded job goals or were below job goals by less than 1 FTE job.

Sometimes the jobs created were not permanent.

panies for which information was available, we found 21 did not maintain employment levels at the level agreed to.

- Three of the companies had gone out of business, five did not meet their job goal within two years as required, and thirteen met their job creation goal but employment levels fell after the project was "closed out."¹

Employment levels at five companies fell to levels lower than when they had applied for the loans. One company had a forgivable loan but had not met its job goals in the required two-year period.

We also examined the wage levels of the jobs created and determined whether they included benefits. As Table 2 shows, we found that:

- The average wage of the jobs created with assistance from the Economic Recovery Fund was \$8.64 per hour; the median wage was \$7.20 per hour.

The average wage of the jobs created was \$8.64, although the median was \$7.20.

¹ Since December 1994, one additional company with 109 jobs has gone out of business.

**Table 2: Economic Recovery Fund, FY 1991-95,
Average and Median Wage by Region**

<u>Region</u>	<u>Number of Projects</u>	<u>Number of Jobs</u>	<u>Median Wage</u>	<u>Average Wage</u>	<u>1993 Region Average Wage¹</u>
Central	22	1,173	\$7.00	\$8.18	\$9.54
Metro	16	1,069	9.00	10.78	13.85
Northeast	9	483	7.26	9.35	10.63
Northwest	6	600	5.95	6.73	8.88
Southeast	29	913	7.71	9.12	10.48
Southwest	13	253	6.58	7.95	8.89
West Central	10	488	5.50	6.20	8.62
Total	105	4,979	\$7.20	\$8.64	\$12.36

Note: "Economic Recovery Fund" refers to both the state and federal funded programs. The table includes all projects for which wage information was available.

Source: Program Evaluation Division analysis of the Department of Trade and Economic Development reports.

¹1993 Minnesota Average Covered Employment and Wages, Department of Economic Security.

**Wage levels
have increased
slightly, but
inflation
probably
accounts for
some of the
increase.**

Table 3 shows the average and median wages by the year of the project's origination.² The table shows a slight trend of increasing wages by the year of project origination, although some of the increase may be due to inflation. Table 4 shows that state grants and loans tended to create jobs with higher wages than those from the federal program.

**Table 3: Economic Recovery Fund, FY 1991-95,
Average and Median Wage by Fiscal Year of Award**

<u>Fiscal Year Project Originated</u>	<u>Number of Projects</u>	<u>Number of Jobs</u>	<u>Median Wage</u>	<u>Average Wage</u>
1991	7	205	\$6.79	\$7.36
1992	17	619	7.00	7.57
1993	26	1,070	7.40	9.22
1994	32	1,682	7.00	8.31
1995	23	1,404	7.50	9.26
Total	105	4,979	\$7.20	\$8.64

Note: "Economic Recovery Fund" refers to both state and federal funded programs.

Source: Program Evaluation Division analysis of Department of Trade and Economic Development data.

² DTED has required companies to report on wages and benefits since 1993. Because of the way companies report to DTED, the jobs could have been created in any fiscal year. For example, projects originating in 1991 could have hired people and reported to the department in 1993. The department also notes that the numbers for 1994 and 1995 may change as more jobs are created.

**Table 4: Economic Recovery Fund, FY 1991-95,
Average and Median Wage by Source**

<u>Source</u>	<u>Number of Projects</u>	<u>Number of Jobs</u>	<u>Average Wage</u>	<u>Median Wage</u>
State	89	4,160	\$8.87	\$7.50
Federal	16	819	7.51	6.00
Total	105	4,979	\$8.64	\$7.20

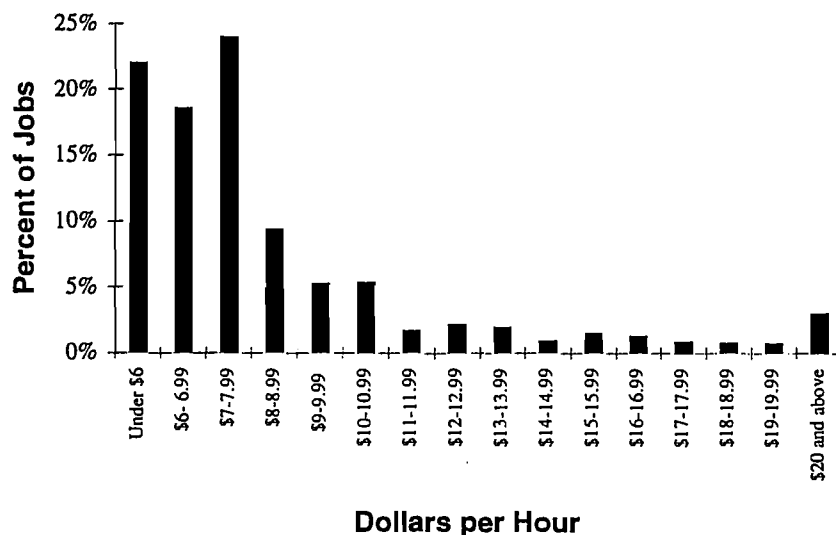
Note: The table includes all jobs for which wage information was available.

Source: Program Evaluation Division analysis of the Department of Trade and Economic Development reports.

**The
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Figure 1 shows that the distribution of jobs is skewed towards lower wage levels, with 63 percent of the jobs paying less than \$8.00 per hour. One explanation for this pattern is that projects funded by the federal Community Development Block Grant (CDBG) are required to fill 51 percent of the jobs created with low and moderate income (LMI) individuals. Also, state rules have been interpreted to require the state-funded program's jobs be filled by or "made available to" LMI persons. The department has interpreted this to mean that the jobs should not require specialized training. However, in the current economic environment, when unemployment rates in many areas of the state are around 3 percent, the Legislature might want to reconsider the LMI restriction on state funds. In our opinion, the state program should have the flexibility to assist companies that create jobs that require specialized training and offer higher salaries.

**Figure 1: Economic Recovery Fund, FY 1991-95,
Wage Distribution**



Note: "Economic Recovery Fund" refers to both the state and federal funded programs.

Source: Program Evaluation Division analysis of Department of Trade and Economic Development reports.

Most jobs that were created provided employee benefits.

We recommend:

- **DTED should separate the requirements for state Economic Recovery funds from the federal CDBG program, thus permitting assistance to companies that create high-wage jobs.**

We also examined whether the jobs created by the grants and loans provided benefits and found that in most cases they did. For the jobs for which information was available, we found:

- **Approximately 90 percent of the jobs created provided health care, 56 percent dental benefits, 85 percent life insurance, and 62 percent retirement benefits.**

“Gap Financing” Versus “Incentive Financing”

Another important issue is whether the Economic Recovery Grant program should provide assistance only to businesses that can demonstrate financial need, or whether it can be used as an incentive for businesses to remain, relocate, or expand in Minnesota even if they could do so without financial help from the state. The former strategy is often known as “gap financing,” while the latter is called “incentive financing.” In our review of projects funded since 1991 we noted some projects where there was no evidence of financial need for the company assisted.

- **Even though the 1995 Legislature tried to limit “incentive financing,” DTED has continued to award some “incentive” grants and loans.**

The department has given a liberal reading to the 1995 legislation, interpreting it to mean that a company being offered incentives by other states cannot otherwise secure “sufficient financing.” This interpretation has allowed DTED to make awards to firms that considered relocating a portion of their business in other states but were able to fund their project internally or through market financing.

Because of the apparent inconsistency between the statute and DTED’s current practice, we recommend:

- **The Legislature should further clarify the goals and purpose of the program and provide clearer direction on whether it wants to allow “incentive financing.”**

The Legislature needs to give the department clearer directions about the program’s purpose.

There are two aspects to this: first, deciding whether “incentive financing” should be included under the program, and, second, if “incentive financing” is permissible, under what rules it should be administered. The Legislature may 1) allow unrestricted incentive financing, 2) allow incentive financing under some circumstances, 3) prohibit incentive financing altogether (and strengthen the language in statute), or 4) provide for separate pools of money for the two types of financing, each with its own eligibility criteria.

The Legislature might consider restricting "incentive financing" to infrastructure or job training purposes.

Since there is a great deal of competition between states for expanding companies, the Legislature might consider allowing "incentive financing" in some circumstances, but restrict the funding to infrastructure or job training purposes. In that way, the funding would provide an investment in the state's physical or human capital while providing a less direct subsidy to the benefiting company.

Grant Criteria and Approval

We also evaluated DTED's current process for reviewing applications and determining eligibility for projects and found that it could be improved. The current Economic Development Score Sheet includes important elements that are subjective, measures the same criteria more than once, gives preference to projects outside the metro area, utilizes criteria that do not differentiate between projects, and does not consider the wage level and benefit availability of the jobs to be created.

We recommend that:

- **DTED should revise its scoring system for the Economic Recovery Fund.**

In our opinion, the revised scoring sheet should eliminate subjective criteria and criteria that do not differentiate projects and it should consider the job type, wage, and benefit level. The scoring sheet should also consider demographic factors on some type of relative sliding scale basis.

LOCAL ECONOMIC DEVELOPMENT

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

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

Most projects had multiple financial participants.

For example, we found that most projects funded by the Economic Recovery Fund between 1991 and 1995 had local or regional financial participants such as city, county, or regional revolving loan funds, tax increment financing (TIF), Economic Development Agencies (EDAs), Regional Development Commissions, regional initiative funds, power companies, and a wide variety of other financial entities. We found that the average Economic Recovery Fund project between 1991 and 1995 had three sources of financing in addition to the state.

Public financing other than the Economic Recovery Fund was a part of 136 of the 176 funded projects: Thirty-five of the projects used local revolving loan funds, 40 used tax increment financing, and 56 used loans from the Minnesota initiative funds. These 136 projects received an average of over \$586,000 in public grants or loans for about \$80 million, not including \$33 million from the Economic Recovery Fund. In other words, the state Economic Recovery Fund provided only

slightly over 29 percent of the public financing for the projects that were funded. Claims about the numbers of jobs created need to take into account the fact that there are often multiple sources of public subsidy for the projects.

There is no comprehensive data source on local revolving loan funds. We surveyed local governments and found:

- **Over 237 local revolving loan funds exist, up from 157 in 1989. Capital has grown to over \$110 million, up from \$42 million in 1989.**

Local revolving loan funds had over \$110 million in capital and made almost 2,300 loans in the last five years.

The 237 funds made almost 2,300 loans between 1990 and 1994. However, 27 funds made no loans, another 27 made only one, and 20 funds made only two loans during the five year period. Forty-seven percent of fund administrators told us they had more capital available than the amount of loans requested during the previous 12 months, 23.9 percent responded that the amount of capital was equal to the loans requested, and 22.9 percent said that the capital was inadequate for the loans requested. Although there was over \$110 million in total capital statewide, the median fund had only \$101,000 in total assets. Of the \$110 million in total assets, there was over \$35 million available to lend.

Based on our findings, we think that it might be advantageous to manage loan funds on a regional instead of local level. Administering loan funds regionally would allow for portfolio diversification that only the very largest funds have now. Regional funds also could avoid the problem of having to carry large balances when good lending opportunities are scarce. Regional funds could also benefit from economies of scale and could afford more professional management than individual communities. Therefore, if the Legislature wants to continue to provide loan funds to local communities, we recommend that:

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

Loan Repayments and Defaults

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

We found that:

- **Since 1984, the state has received repayment for most past loans over \$100,000, although 10.4 percent of companies have gone out of business and defaulted.**

We found that 33 of 318 companies have gone out of business, and defaulted on 6.7 percent of the funds lent. For federally financed projects, 11.3 percent of the companies have gone out of business, defaulting on 8.9 percent of the funds lent. The default rate appears to have decreased in recent years. In part, this is because many of the more recent loans have not had to begin repayment yet. It is also probably partially attributable to a change of policy at DTED to not make loans for working capital. Loans for working capital tend to be riskier and have a higher default rate.

The state General Fund is scheduled to receive repayments of \$1,205,000 in fiscal year 1996, \$1,455,000 in fiscal year 1997, and \$1,174,000 in fiscal year 1998. As of June 30, 1995, over \$1.7 million had been repaid to the General Fund and an additional \$19.3 million is scheduled to be repaid in the future. As of June 30, 1995 almost \$3.5 million in loans had been repaid to the Economic Recovery Fund.

OTHER DTED LOAN PROGRAMS

We also examined the Rural Challenge Grant, Capital Access, and Small Business Development Loan programs.

Rural Challenge Grant Program

The 1987 Legislature created the Rural Challenge Grant program to provide job opportunities for low-income individuals, stimulate private investment, and promote economic activity in rural areas. The original appropriation included \$5 million of federal funds and \$1 million of state funds; in 1993, an additional \$6 million was allocated. Money from the state provides up to half of the Challenge Grant dollars and a regional initiative fund provides the rest. Between fiscal years 1989 and 1994, initiative funds made 393 challenge grant loans for a total of almost \$23 million. The average loan size statewide was \$58,032.

We found that 369 projects receiving Challenge grants between fiscal years 1989 and 1994 created over 6,400 full-time and over 740 part-time jobs. The average wage of new full-time jobs created was approximately \$7.67. Of the new full-time jobs, approximately 54 percent offered health care, 11 percent offered dental coverage, 36 percent offered life insurance, and 23 percent offered retirement benefits.

We have some concerns over the accuracy of job creation data. The initiative funds report data in different formats and do not clearly define job creation, wage, and benefit information presented in the annual reports. In addition, for over half of the companies receiving loans in 1994, some information reported by the initiative funds in their annual reports was different from the information reported for DTED's performance reports. We recommend that DTED should provide guidance and instruction to the initiative funds on collection, calculation, and reporting of data and develop a standardized reporting format.

Challenge grants created over 6,400 jobs at an average wage of \$7.67.

Capital Access Program

The 1989 Legislature created the Capital Access program to encourage banks to make loans to businesses, particularly small and medium-sized businesses, that have difficulty obtaining commercial loans. DTED, the borrower and lender each contribute a percent of the loan to a reserve fund established at the lending institution. The idea is that a bank will make several Capital Access loans, creating a portfolio covered by the reserve fund containing the contributions for all of the enrolled loans. As of October 30, 1995, 17 banks had made 128 loans worth over \$4.5 million in the Capital Access program. The average Capital Access loan was \$36,315.

Although it is popular among bankers to whom we spoke, less than 6 percent of Minnesota banks are signed up to participate in the Capital Access program. We think that DTED should investigate why more banks do not participate in the program.

Small Business Development Loan Program

The Small Business Development Loan program provides loans to small businesses through the issuance of tax-exempt revenue bonds. The businesses must be manufacturers and have fewer than 500 employees. Between 1985 and 1995, the program issued over \$50 million in bonds and made 38 loans ranging from \$250,000 to over \$4 million. The average Small Business Development loan is approximately \$1.4 million, with a median of \$1 million. Four loans have defaulted, resulting in a loss of over \$2 million. DTED obtained job creation information for 23 companies. The 23 companies promised to create 642 jobs, and ended up creating 1,312. Twenty of the companies reported meeting or surpassing their job creation goals.