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Minnesota's Economic Recovery Fund

Positive Results, Room for Improvement

Since 1984, Minnesota has been channeling $8-$9 million per year in loans and grants to businesses through a fund that aims to stimulate State and local economic growth, aid distressed areas, and help low- and moderate-income people. The program sends 90 percent of its funds to nonmetro areas, with moderate success. Forty percent of the nonmetro projects appeared to contribute to economic growth within the State (1984-88), and the most economically distressed counties received more than their share of projects. However, most of the created jobs paid lower wages than the local average.

Minnesota's Economic Recovery Fund (formally titled the Small Cities Economic Development Program) spends considerable money—$8-$9 million each year from 1984-88—to stimulate economic growth in the State, redistribute economic activity to distressed areas within the State, and benefit low- and moderate-income people. About 40 percent of the projects sponsored by the fund may contribute to economic growth within the State. Furthermore, the projects most likely to stimulate growth occur in slightly greater proportion in counties with high unemployment rates, high poverty rates, and low median income.

The downside of the program is that most of the jobs created pay low wages, lower than the county average and even below the Federal poverty threshold for a family of four. Further, the fund supported numerous projects that could have been financed by the private sector; the fund subsidized many projects in areas of the State that had few economic problems; and numerous projects had the effect of reallocating growth within prosperous areas.

To be successful in achieving their stated aims, programs like Minnesota's have to stimulate economic activity independent of growth that would have occurred in the State anyway, concentrate efforts in distressed areas, and improve the condition of low- and moderate-income people.

Stimulating State Economic Growth

A central goal of the Economic Recovery Fund is to stimulate economic activity that would not have occurred in the State in the absence of the fund. Ways to increase a program's chances of doing so include targeting loans to viable businesses with inadequate access to private capital markets and to firms that require a subsidy to locate or remain in the State rather than go elsewhere. The Economic Recovery Fund did aim to stimulate State economic growth, but it did not consistently target loans in these ways (see box, "About the Fund").

Financing Businesses Unlikely to Obtain Conventional Loans. Economic development programs are more likely to promote growth (increases in economic activity that can be measured in a range of ways), and not just shifts of activity, if they fund viable projects that the private financing market is most likely to reject incorrectly. Such projects occur disproportionately in small businesses, startups, businesses owned and managed by women and minorities, and businesses making major innovations not tested elsewhere. Such projects are likely to be rejected for private loans even if they are as viable as those that do get financing from private lenders. These projects tend to fail to get private financing because the lenders' costs of getting information on the viability of a loan are significant or information is lacking entirely, because lenders discriminate on the basis of characteristics unrelated to the viability of the loan, because benefits of a project go to many outside the specific business and therefore are not realized in higher business profit, or because collateral is not adequate to back a loan.

The Economic Recovery Fund had mixed results in financing the kinds of projects that were most likely to add to growth in nonmetro areas. The program funded startup businesses that survived at a rate close to the percentage of such businesses statewide (table 1). The fund also financed minority-owned or managed businesses in the same proportion as such businesses exist in the State.

In contrast, the fund did poorly in financing small businesses and businesses owned by women. The program funded only a third as many small businesses as would be expected from the proportion of small businesses in the State. Part of the explanation for this may be that larger loans to large businesses depleted the program funds each year before many small businesses applied. Three percent of proprietorships and partnerships that received financing were owned by women, but women own 10 times this percentage of nonfarm proprietorships and partnerships in the midwestern region that includes Minnesota. Participation of female-owned businesses may have been low because loans went disproportionately to manufacturing firms, and few women run those types of firms. Overall, slightly more than a fourth of the pro-

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Table 1—Projects in nonmetro subsidized businesses by characteristics related to economic growth

More than half the projects funded by the Economic Recovery Fund were in businesses with characteristics that suggested they may have added to economic growth.

Characteristic	Projects in nonmetro businesses funded by the Economic Recovery Fund[1]	All Minnesota businesses[2]
	Percent	
Private financing constraints:		
Startup business	7	4-10
Minority ownership or management	3	3
Small business, fewer than 20 employees	27	78-87
Female-owned nonfarm proprietorship or partnership[3]	3	32
Innovating in product or process	2	NA
Subtotal	25-28	NA
Operating in nonmetro area rather than outside the State	13-14	NA
Operating in economically distressed counties:		
Located in 1/5 of counties with--		
Highest unemployment rate	18	10
Highest poverty rate, 1979	14	6
Lowest median income, 1979	13	5
Subtotal	28-30	14
Total	50-55	NA

NA = No comparable number available.

Note: Subtotals and totals are not sums of the entries in the table because categories are not mutually exclusive; many projects had several of the characteristics.

[1]Ranges are due to missing interview data. One number excludes the missing cases and the other includes estimates of the missing information.

[2]Ranges are the low and high estimates reported in various studies of these characteristics.

[3]Percentages of nonfarm proprietorships and partnerships, not of all businesses. The percentage in the State column is for the region including Minnesota. No State-level information was available.

jects in nonmetro businesses had at least one risk characteristic that would likely discourage private financing.

To be successful, programs like Minnesota's need not only to identify businesses overlooked by private lenders but also to avoid projects that private lenders were right to reject. More than 15 percent of the businesses that received program funding during 1984-88 were not operating by mid-1989. This failure rate was 30 times the 0.5 percent of all Minnesota business establishments that discontinued operations each year. A higher failure rate is expected for a program that seeks to fund businesses that cannot get financing elsewhere, but the fund's failure rate seems high.

Financing Businesses that Could Have Gone Elsewhere. The Economic Recovery Fund can also bring about economic growth in nonmetro Minnesota by retaining or attracting businesses that would move out of the State or would choose not to locate in the State without the fund. Although this approach, if successful, does add to a State's nonmetro growth, the use of subsidies for this purpose is problematic. If the subsidies are successful, States spend money to move businesses around the country with no benefits for the Nation as a whole. Further, much of the money may be wasted as States finance businesses for doing what they would have done anyway. The approach encourages businesses to play States against each other to increase the package of benefits in the location they will choose anyway.

About 15 percent of the surviving businesses were operating in Minnesota's nonmetro areas rather than outside the State because they had received subsidies.

Overall, close to 40 percent of all the subsidized projects were in businesses with at least one of the characteristics likely to discourage private financing or in businesses operating in the State that would not have done so otherwise. Manufacturers undertook four-fifths of these projects, and service providers implemented most of the rest. This industrial distribution is about the same as for all firms that received funding. In contrast, local residents owned a larger percentage of the businesses with projects most likely to cause growth than of other funded businesses.

The business with projects most likely to lead to growth used their loans for a variety of purposes. Two-thirds of the businesses expanded. A fifth moved to new sites, most to a different location in the same city or town. More than a tenth of the projects involved purchases of businesses, many of which had threatened to close.

The fact that so many projects have one or more characteristics that discourage private lenders suggests that State and local business loan programs like Minnesota's hold considerable promise for increasing growth even though small businesses and female-owned proprietorships and partnerships were underserved. To draw firmer conclusions about program effectiveness, an analyst would need more detailed information on applicants, including other characteristics that might cause lenders to reject them when they were as viable as applicants that did receive funding. A full evaluation should also include information on the effects of the projects on tax bases, number of jobs, and the cost of encouraging this growth compared with the cost of bringing about growth in other ways (see "For Additional Reading..."). In addition, because the funds the businesses repay often seed a local revolving loan fund, a more complete look at the growth effects of the program would also examine subsequent loans from the revolving loan funds. (See the Stinson and Lubov article in this issue for an examination of revolving loan funds in nonmetro Minnesota.)

Redistributing Economic Activity to Distressed Areas

To achieve its second goal, redistributing economic activity to distressed areas, the Economic Recovery Fund needs to concentrate efforts in lagging regions. This effort may also increase State economic growth, but not necessarily. Viable projects in economically distressed areas are less likely to receive private market financing than equally viable projects in prosperous areas. Lenders may tend to overestimate risk in lagging regions and to underestimate risk in growing areas. When nonmetro areas are economically distressed, local financial resources may be concentrated in one or two institutions. In these cases, banks' monopoly power or their inability to structure loans that meet a range of business needs may restrict credit. If these tendencies are true (they have not been demonstrated conclusively), an economic development program that seeks to finance a disproportionate share of projects in distressed, nonmetro areas may also stimulate economic growth.

The fund did well in disproportionately financing businesses in economically distressed areas of the State whether distress was measured by county unemployment rate, poverty rate, or median income. The Economic Recovery Fund supported projects in economically distressed areas at rates much higher than the proportions of the State's businesses in those counties (table 1). Close to 30 percent of the subsidized businesses were in counties that had at least one indicator of severe economic distress (fig. 1). The most distressed counties also received more than their share of program funds. Projects most likely to bring about economic growth—those in businesses likely to be overlooked by private lending sources or operating in the State because of the subsidies—were located in the most distressed counties in larger numbers than a proportional share.

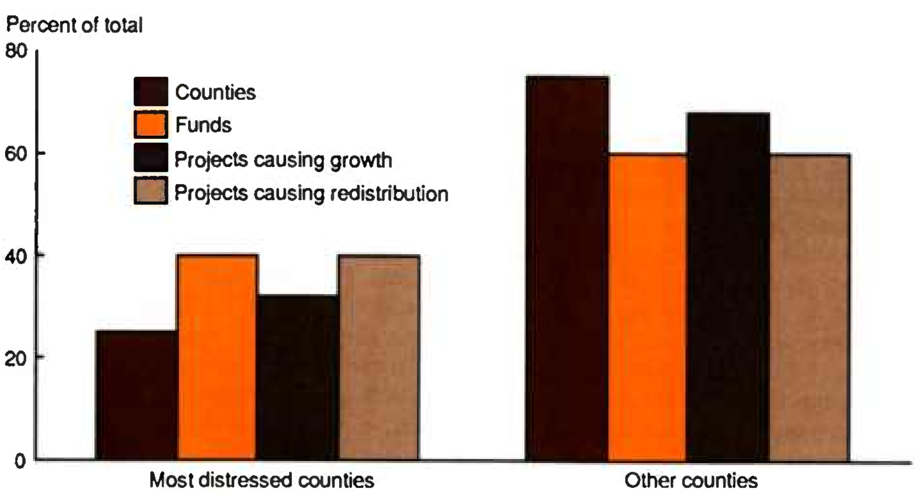
Some of the projects the Economic Recovery Fund funded in distressed areas simply moved activity around the State. The fund was considered to have redistributed economic activity when it financed a project that managers said would not have occurred without the funds but the business lacked other characteristics indicating that it was likely to add to economic growth. Because the fund could have financed projects elsewhere in the State that also would not have occurred without the funds, the effects of these projects are to shift economic activity within the State. This kind of project occurred disproportionately in the most distressed counties (fig. 1).

Despite the success the fund had in redistributing growth to distressed areas, the program could have been aimed more directly at distressed areas. The 50 percent of counties with the higher poverty rates received just over 40 percent of total program funds. The 30 percent of counties with lower poverty rates received slightly over 40 percent of program funds. More subsidies could have gone to more distressed regions without taking funds from businesses that lack access to credit.

Figure 1

Distribution of funds and projects between most distressed and other counties

Most distressed counties received more than their proportionate share of Economic Recovery Fund dollars and projects.



Note: "Most distressed" counties are in the lowest median income quintile and the highest poverty rate quintile or the quintile of counties with the highest unemployment for at least four years of the program.

Benefiting Low- and Moderate-Income People

The third goal of the program was to improve the conditions of low- and moderate-income people. The Economic Recovery Fund records show that low- and moderate-income people were employed or had the opportunity to be hired for at least 51 percent of the jobs delivered. However, most of the jobs in businesses whose projects led to economic growth (in businesses likely to be overlooked by private lenders, operating in distressed counties, or operating in the State instead of elsewhere) paid so little that many of the people who held the positions kept their low- and moderate-income status after they took the jobs. Furthermore, the jobs that businesses created paid less than the businesses had forecast when they applied for the subsidies.

None of the jobs that businesses promised to provide were expected to pay as low as the minimum wage, but more than one-third were expected to pay at or below the poverty threshold for a family of four (table 2). Three-fourths of the promised jobs were to have paid less than the average annual earnings per job in the county.

Although average earnings per job rose during 1984-88 in almost every county, the subsidized businesses created jobs that paid even less than they had foreseen. More than 10 percent paid the minimum wage. Three-fifths of the jobs paid a salary at or below the poverty threshold for a family of four. Eighty-five percent paid less than the average earnings per job in the county at the time the business proposed the project. The effect of the subsidized jobs was to lower county average earnings compared with what they would have been without the fund.

Table 2—Earnings levels of jobs created by the nonmetro subsidized firms most likely to have led to State economic growth

Jobs created often paid less than foreseen in the loan application and less than the county average.

Earnings	Promised jobs	Created jobs
	Percent	
Greater than or equal to county average wage	25	15
Less than county average wage	75	85
Greater than poverty threshold[1]	65	39
Less than or equal to poverty threshold[1]	35	61
Greater than minimum wage	100	89
Equal to minimum wage	0	11

[1]Poverty threshold for a family of four in 1987 was $11,611 annual income.

The jobs paid little even though more than three-fourths of the businesses that received financing were in manufacturing, a sector with high average wages. The average weekly wage for a job in a manufacturing firm in Minnesota in 1986 was more than $500. Average weekly earnings for a nonmetro manufacturing job in a subsidized firm amounted to less than half that amount. These earnings patterns are not unique to the businesses most likely to have led to economic growth. All subsidized businesses averaged low wages and lower wages than promised.

Lessons for State and Local Business Loan Programs

This analysis suggests that greater emphasis on funding projects in businesses that private lenders are likely to overlook incorrectly would improve the Economic Recovery Fund's record in encouraging economic growth. The program's success does not reflect a concerted effort to fund such businesses. While the application guidelines and assessment process encouraged local jurisdictions to discuss how their proposed projects would support the economic viability of small or minority- or female-owned businesses, such factors had little effect on the way an application was rated (see "For Additional Reading..."). Earmarking funds for small businesses, startups, businesses owned by women and minorities, or businesses engaged in innovative projects is likely to have a greater chance of bringing about economic growth (and increases in private investment, the tax base, and jobs) as opposed to merely shifting resources from one place to another within the State.

More detailed assessment of the financial needs of businesses to ensure that they cannot obtain private financing would also improve the program's chance of encouraging economic growth. Although the application called for information on the business's "financing gap," documentation was often missing. Only 6 percent of business managers and owners whose businesses had received funding stated that they had exhausted all other possible sources of financing. Local officials have many reasons to put forward applications from businesses having no credit problems or from risky projects that will never succeed. For instance, one local official called a loan on behalf of a business that could have received private financing a "win-win" situation. The city got a "nest egg" for a revolving loan fund, and the business received a low-interest loan. In other cases, local officials backed nonviable projects out of wishful thinking or misplaced enthusiasm; they needed economic development projects to demonstrate that they were working to relieve their area's high unemployment. To counter these local pressures, administrators at the regional or State level could assume greater responsibility for financial assessment.

Effective program administration also suggests a need to ensure that subsidies truly influence business decisions to remain or locate in a State. When a business owner threatens to leave the State because of high workers' compensation costs or high income taxes, the loan program should evaluate business costs in alternative locations. Although a move may reduce workers' compensation, for example, it may raise other costs or cut ties with important customers. If programs subsi-

About the Study

This study uses data from the files of the Economic Recovery Fund for approved projects from its start in 1984 through late 1988. In addition, managers were interviewed in 63 percent of the subsidized businesses in nonmetro areas.

Ninety percent of the fund's activity was in nonmetro areas. Subsidies went disproportionately to nonmetro areas for at least two reasons. For one, cities and counties receiving Federal Community Development Block Grant funds as entitlement jurisdictions were not eligible to receive grants from the federally funded part of the Economic Recovery Fund (see box "About the Fund"). For another, the fund's emphasis on community economic distress benefited nonmetro areas more than the more prosperous metropolitan region.

Grants to 152 cities, counties, townships, and Indian reservations outside metropolitan areas were approved during 1984-88. These communities were awarded 188 grants; 7 of these grants were cut off with virtually no funds spent. The local jurisdictions in turn offered financing or undertook projects on behalf of 191 businesses, of which 10 received more than one grant or loan.

About the Fund

The Minnesota Economic Recovery Fund (officially the Small Cities Economic Development Program) provides financing for businesses and projects that assist businesses. Funding comes from two sources: the Economic Recovery Grant program funded by the State and the Small Cities Development Program funded by the Federal Small Cities Community Development Block Grant program. A local government applies to the State Department of Trade and Economic Development (DTED) for funding on behalf of a business or several businesses. The local jurisdiction usually lends the money to the businesses, although occasionally a business receives a grant. When a business repays the loan, the local government deposits some or all of the repayment plus interest in a revolving loan fund for economic development.

To be eligible for funds, the projects that businesses propose must meet at least one of three Federal objectives: to benefit low- and moderate-income people, to prevent or eliminate slums or blight, or to alleviate an urgent community development need. In addition, a project must meet at least two State objectives: to create or retain permanent private-sector jobs, to leverage private investment, or to increase the local tax base. An applicant also needs to document a "financing gap" that the business experiences, demonstrating a need for the program funds.

DTED considers funding a business's project if the application receives at least 400 of a possible 600 points. Applications receive points for community need, impact on the community, and financial feasibility and cost effectiveness of the project. Points for community need are awarded for annual and quarterly unemployment rates and a U. S. Census of Population poverty rate higher than the State's rates and for Census median income lower than the State's. A narrative that assesses the problems of the community receives up to 80 points and provides information on the economic vulnerability of the community, events contributing to a depressed economy, the nature of unemployment, need for essential services, events contributing to a unique situation, the number of businesses recently lost and started, infrastructure condition, outmigration, timeliness of the project, and labor pool needs. The application receives points for impact on the community based on the number of jobs associated with the project, the ratio of grant funds to jobs, the increase in the tax base, the speed with which the project can be undertaken and completed, evidence that a project will enhance energy efficiency, and commitment to train low- and moderate-income people. Applications receive points for financial feasibility and cost effectiveness based on the business's need for program funds, the ratio of private funds to program funds, the ratio of all other funds to the program's funds, and the loan's interest rate.

dize businesses for locating and expanding where they would have done so anyway, the programs have no positive effects on growth.

The analysis suggests that loan programs might be able to improve on the Minnesota program's record in redistributing economic activity to distressed areas. For example, the application criteria for what constitutes community need could be clearer, and communities with fast-growing economies could be excluded from programs, although mechanisms should be in place to include communities whose fortunes turn bad. When serving distressed areas is the purpose of the program, areas with higher unemployment and poverty and lower incomes should be favored over those with healthier economies. A loan program could be widely promoted and projects encouraged in the most distressed areas of a State. In Minnesota, applications from more prosperous areas received many points for narratives on community economic distress. In addition, the application gave no advantage to areas with especially high unemployment or poverty compared to those with rates only slightly higher than the State's overall rates.

Business loan programs generally help low- and moderate-income people, principally by subsidizing businesses that offer low-wage jobs. The created jobs offer options that many workers find better than other choices, as workers demonstrate when they take the jobs. An alternative is for programs to focus on assisting fewer people to significantly increase their income by ensuring that the funds subsidize higher paying jobs or jobs that provide training for better jobs. Although the Economic Recovery Fund awarded points to an application for evidence of a commitment to train workers, the training did not need to be for skilled work or for jobs that would lead to more skilled work. A program that aimed to provide higher paying jobs might require complementary programs in job training and assistance with research and development.

These improvements, including a management information system to monitor progress, would better the chances that business loan programs increase economic growth, assist distressed areas, and help lower income people. However, program staff would still face dilemmas in carrying out their charge. First, if a program is to benefit low- and moderate-income people, a subsidy to business is a blunt, indirect tool whose success depends on what a subsidized business does. Second, although programs aim to encourage State economic growth, goals of local officials are often inconsistent with efforts to benefit the State. For instance, local officials may seek funds to "pirate" a business from another town. Third, the program is to deal with community and economic development needs, but what subsidies to businesses do best is help the businesses that receive the funds. Programs generally do not look for ways to ensure that businesses meet broader community needs—by funding businesses that make more local purchases, for instance.

When projects receive funds based on their contribution to community needs, meeting the community needs directly might often be more effective. For instance, the Economic Recovery Fund funded a laundromat partly in response to the community's need for a place where elderly people could walk to wash their clothes. For less money, city officials could have bought washing machines for the elderly residents. The inconsistency between the goals of meeting community needs and of stimulating economic growth through business subsidies leads to funding projects that either do not encourage growth or have few community benefits. These dilemmas suggest that administration of loan programs should include consideration of which program goals are most important and whether business loans are the best way to achieve those aims.

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