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Inside State and Local Economic Development Programs: The Record of Minnesota's Small Cities Economic Development Program

by

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Programs that subsidize businesses to stimulate economic development in distressed areas outside big cities face formidable odds against their success, according to research on the effects of these programs. Evaluations conclude that past efforts to provide business financing in distressed areas have not influenced either the level or the distribution of economic growth.[1] These studies provide virtually no insight into why programs have had limited impact. Many evaluations focus on innovative ways of comparing what happened with the programs to what would have happened without them. While the research contributes to developing better methodology for evaluation, these studies offer few ideas on what state and local decision makers can or should do differently to make the programs encourage growth in distressed regions, the explicit aim of many programs.[2]

The conclusions of existing studies--essentially that the programs do not work--go almost unheeded by state and local policy makers. Since the early 1980s, as state and local officials have become major actors in dealing with regional economic problems, many of their efforts have involved financing business under a variety of terms to stimulate new economic activity. If past efforts to use business financing to stimulate economic development at the state level and in distressed areas have not worked, better

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[1] For a review of the literature that evaluates these programs, see Margaret E. Dewar, "Tax Incentives and Public Loans and Subsidies: What Difference Do They Make in Nonmetropolitan Economic Development?" in Financing Economic Development, eds., Richard D. Bingham, Edward W. Hill, and Sammis B. White (Newbury Park, CA: Sage, 1990).

[2] Ibid.

understanding is needed to inform new policy making about how new programs might work and what would make them more successful than in the past.[3]

This paper looks at an economic development program, Minnesota's Small Cities Economic Development Program, to examine and assess the program's results. This study offers a more detailed look at a program than other evaluations that typically rely on aggregate data about program activity and the regional economy. As a result, this examination can better assess why the program succeeded or failed. This paper first describes the Small Cities Program, then looks at its results, and finally suggests ways the program could better achieve its explicit goals.

Minnesota's Small Cities Economic Development Program

The Minnesota Small Cities Economic Development Program provides financing for businesses and projects related to businesses, such as infrastructure improvements. A local government applies to the state Department of Trade and Economic Development (DTED) for a grant on behalf of a specific business. The local jurisdiction usually lends the money to the business, although occasionally the business receives a grant. When the business repays the loan, the local government deposits some or all of each grant plus interest in a revolving loan fund for economic development.[4]

[3] Harold Wolman, "Local Economic Development Policy: What Explains the Divergence Between Policy Analysis and Political Behavior?" Journal of Urban Affairs, vol. 10, no. 1 (1988); National Association of State Development Agencies et al., Directory of Incentives for Business Investment and Development in the United States: A State-by-State Guide (Washington, DC: Urban Institute Press, 1983 and 1986).

[4] "Minnesota Small Cities Economic Development Program Application Manual," Department of Energy and Economic Development (DEED), St. Paul, MN, January 1986.

The program has two major sources of funds. One is the state-administered allocation of federal Small Cities Development Program grants, a part of the Community Development Block Grants program. The other is the state's Economic Recovery Grants, a program created in 1984 to supplement federal funds. Any jurisdiction can apply for funds under the state program. Indian tribes and the state's largest cities and urban counties are not eligible to receive funds from the federal part of the program because they may receive Community Development Block Grant funds directly from the U.S. Department of Housing and Urban Development.[5]

From 1984 through late 1988, the Small Cities Economic Development Program received annual funding between $8 million and $9 million (of this, between $5 million and $6 million came from the state and approximately $3 million came from the federal government). During this period, the program's administrators approved grants to 162 cities, counties, townships, and Indian reservations, although five of these jurisdictions later received no funding when projects fell through. The administrators approved a total of 205 grants; eight of these were later terminated with virtually no funds spent. Local jurisdictions offered financing to or prepared to undertake projects on behalf of 209 businesses; nine of these businesses ultimately received no financing;

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[5] Minnesota Statutes, ch. 116J.873, "Economic Recovery Grants;" Minnesota Rules, ch. 4300; "Minnesota Small Cities Economic Development Program Application Manual," especially page 1; U.S. Code 42, ch. 69, "Community Development;" Code of Federal Regulations 24, ch. 5, subch. C, pt. 570, April 1, 1988.

ten businesses received more than one grant or loan. The loans or grants to businesses ranged from $10,000 to the legal limit of $500,000.[6]

The Small Cities Economic Development Program is an useful vehicle for examining state and local efforts to stimulate economic development through business subsidies. First, the program is a common type; findings should be helpful in understanding many other programs. As of 1986, twenty-six states offered direct loans to businesses; fourteen offered grants. Other states have used the federal Small Cities Development Program for similar efforts; for instance, Michigan has a nearly identical program. The Small Cities Economic Development Program is also similar in design to the Urban Development Action Grants Program, which, despite its name, also provided federal funding for rural areas.[7]

A second reason for examining the Small Cities Economic Development Program is that the program is supposed to respond to community distress and help low- and moderate-income people, in part because of its connection with the federal Community Development Block Grants program. The program is more likely than less targeted

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[6] Grants approved for 209 businesses and additional grants approved for ten of the same businesses meant DTED approved funds on 219 occasions for a business or a project in support of a business. Mike Auger, director, Small Cities Economic Development Program, Community Development Division, Department of Trade and Economic Development, St. Paul, MN, personal communication, February 1988; data collected from the project files of the Small Cities Economic Development Program, Department of Trade and Economic Development, St. Paul, MN; Julia Mason Friedman, Research Paper E, "Improving Capital Market Efficiency Through State Programs," in <u>The Report of the Governor's Commission on the Economic Future of Minnesota</u> (St. Paul: Department of Trade and Economic Development, 1987), p. 147.

[7] National Association of State Development Agencies et al., <u>Directory of Incentives</u>; The Capital Group, Office of Federal Grant Management, "Final Program Statement: 1988 Michigan Community Development Block Grant Program," (Lansing: Michigan Department of Commerce, n.d.); Edward T. Jennings, Jr., et al., eds., <u>From Nation to States: The Small Cities Community Development Block Grant Program</u> (Albany: State University of New York Press, 1986); Marie Howland and Ted Miller, "Urban Development Action Grants to Rural Communities," Project Report, Urban Institute, Washington, DC, May 1988.

efforts to deal with two issues of importance to many state and local governments--regional decline and economic distress in nonmetropolitan areas.

Third, the Small Cities Economic Development Program has existed longer than any other major state economic development program in Minnesota. As in every state, a large share of Minnesota's economic development efforts are short-lived. Survival and longevity mean data exist, albeit often in the form of voluminous written materials in file cabinets rather than computer-ready numbers; the program has results to be evaluated and explained.

Further, because the Small Cities Economic Development Program has survived so long, the program may offer an example of an effort that is more likely to be successful than others. The Small Cities Program has matured past start-up problems; administrators have had the opportunity to correct difficulties they might have identified early in the program's implementation.

The Results of the Small Cities Economic Development Program

To assess the results of the Small Cities Economic Development Program, this study addressed four major questions. First, what were the program's explicit goals? Second, what did the program need to do to achieve these goals? Third, did the program take these actions? Finally, given the necessary actions and the program's activities, is the program likely to have been successful in achieving its goals?

The primary objective of the program came from the federal Community Development Block Grants legislation--"the development of viable urban communities, by. . .expanding economic opportunities, principally for persons of low and moderate income."[8] The state legislation added that the Economic Recovery Grants were "to create new employment, maintain existing employment, increase the local tax base, or otherwise increase economic activity in a community."[9] Every project was to meet at least one of three federal objectives to "benefit low- and moderate-income persons," to "prevent slums and blight," or to "alleviate urgent community development needs."[10] Every project was to meet two of three state economic development objectives: "creation or retention of permanent private sector jobs," "stimulation or leverage of private investment," or "increase in local tax base." Program administrators were to consider the need for an economic development project "based on deficiencies in employment opportunities and circumstances contributing to economic vulnerability." The project was to reduce or eliminate this need.[11]

In addition to these aims stated in legislation and regulations, the governor and the commissioner of DTED (previously the Department of Energy and Economic Development--DEED) touted the program as creating jobs for the state. They made frequent announcements, especially in the early years of the program, about the number of jobs the program created in the state. When they announced specific projects, they

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[8] U.S. Code 42, ch. 69, sec. 5301c; see also, Minnesota Rules, ch. 4300, pt. 0300.

[9] Minnesota Statutes, ch. 116J.873, subd. 2.

[10] Minnesota Rules, ch. 4300, pt. 0300.

[11] Ibid., pt. 1901.

emphasized the number of jobs to be created. Because of this emphasis, the program results should be considered with respect to this goal as well.[12]

Achieving these goals and objectives involved two not entirely separate kinds of outcomes, one leading to economic growth and the other to redistribution of economic activity or income within the state or a community. Creating new employment, maintaining existing employment, increasing the tax base, or stimulating private investment either in the state or in a specific community involved stimulating economic growth. Encouraging growth in employment, private investment, or tax base within a community could be achieved through redistribution without overall economic growth if the program helped a jurisdiction attract economic activity that would have occurred elsewhere in the state. Assisting distressed communities and low and moderate income people may have involved redistribution of growth or income from better off communities and wealthier people. The following sections consider what the program needed to do to accomplish these objectives and look at what the program actually achieved.

As this paper will show, the Small Cities Economic Development Program succeeded in some respects and failed in others. With reforms, the program could become more successful but would continue to confront dilemmas due to inconsistencies in goals of state and local officials and the difficulty of making a subsidy to a private

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[12] "Dayton Says State's Business Climate Improved in 1983," Minneapolis Star Tribune, 2 March 1984; Lynda McDonnell and Steven Thomma, "Economic Development Schooled in Hard Knocks," St. Paul Pioneer Press Dispatch, 2 March 1986; Steven Thomma and Lynda McDonnell, "Rosy Figures of Job Agency Don't Add Up," St. Paul Pioneer Press Dispatch, 2 March 1986; "Perpich Says His Strategy Created, Saved Many Jobs," St. Paul Pioneer Press Dispatch, 17 July 1986; and "Perpich Compiles List of Firms Aided During Last Three Years," Minneapolis Star Tribune, 4 October 1986.

business produce more benefits than other possible programs for low income people or meet community development needs better than other possible approaches.

Achieving Economic Growth in the State and a Community

To achieve its goals, the Small Cities Program needed to bring about an increase in jobs, tax base, or private investment over growth that would have occurred without the program. To do so, the program had to avoid high "opportunity costs" by financing projects that would result in more economic activity than would have existed without the program. When the state and a town provided financing to a business, the funding needed to bring about more growth in the state and in the community than would have otherwise occurred. In other words, the program should have allocated economic resources in better ways than the private market.

Also desirable, although not essential to the program's success, was financing projects that produced more growth than other possible projects. When a town provided financing to a business, the funding could have gone instead to one of numerous other businesses. The city administrators needed to choose the project leading to the greatest increase in economic growth to make the best use of the public resources. The DTED program administrators needed to make grants to communities that would lead to more growth than grants to other communities in the state.

Dealing with market failure - Any economic development program has difficulty avoiding high opportunity costs and, therefore, achieving more economic growth than would have occurred without the program. One approach is to seek to correct "market failures," occasions when private market decision makers act in ways that are "inefficient," that neither maximize production with certain levels of inputs nor minimize production costs for a level of output.[13]

For the Small Cities Economic Development Program to address market failure and maximize the opportunity to create economic growth, the program needed to finance projects that should have received financing in the private market but were incorrectly rejected for loans. For instance, the program needed to finance projects where the costs of getting information on the viability of a loan were significant for a private financing source or where information was lacking entirely. In addition, the program needed to emphasize projects where private lenders discriminated on the basis of characteristics unrelated to the viability of loans, and the program needed to fund projects with significant positive "externalities"--benefits borne by groups not involved in a specific market transaction. Although occasions when these characteristics exist are difficult to identify, the criteria imply that the program should assist small businesses rather than large; businesses in distressed areas, especially with undiversified economies, rather than in growing areas; businesses owned or managed by minorities and women; businesses producing a new type of product or using a new process rather than older processes and products; start-up businesses more than established firms; and projects emphasizing

[13] For a more detailed explanation, see Robert H. Haveman, The Economics of the Public Sector (New York: John Wiley and Sons, 1976), chaps. 2, 3; or other texts on public sector economics.

training and education to help workers become more productive not only in a specific job in a particular business but also in various jobs in many possible businesses.[14]

These indicators of market failure are not the only possible ones. Market failure might occur in regions served only by small independent banks unaccustomed to making commercial loans or in regions where lending is concentrated in so few institutions that lenders can restrict the number of loans and increase interest charges.[15] Following these guidelines for identifying market failure would not guarantee that the program addressed market failure in every case, for private sector lenders do not reject applications, for instance, from every small business or every female entrepreneur. The program would fund some projects that would have been financed without the program. Nevertheless, the program would have been more likely to deal with market failure and, therefore, to bring about economic growth if program administrators considered how to focus the program on the kinds of projects where market failures were most likely.

What emphasis did the Small Cities Economic Development Program place on dealing with market failure? DTED's program application manual asked local jurisdiction applicants to discuss, if applicable, "how the project will support the economic viability of small or minority or female-owned businesses or other entities which have demonstrated limited access to capital," certainly indicators of market failure. However, the program directed little attention to the failure of financial institutions to identify

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[14] For a more detailed explanation, see Julia Mason Friedman, "Credit Rationing in Non-metropolitan Markets for Small Business Loans," Working Paper 88-02, State and Regional Research Center, University of Minnesota, St. Paul, MN, April 1988.

[15] Ibid.; David Leckey, executive director, Southwest Minnesota Initiative Fund, Granite Falls, MN, telephone communication, December 1990.

good projects in depressed areas or to businesses' failure to provide low-skilled workers with transferrable skills. Communities with higher recent unemployment than the state average and with higher poverty rates and lower median incomes than the state as a whole in 1979 received higher application ratings than more prosperous communities, but most Minnesota communities met this weak definition of need because the prosperous and populous Twin Cities metropolitan area and Rochester raised state averages and medians. Businesses were to hire and train low and moderate income workers, but the training could be limited to that needed for the particular job.[16]

The application manual reflected no insight into the importance of addressing market failure in its instructions on how applicants should show that the project would create and retain jobs, leverage private investment, and increase the local tax base. For instance, an applicant stating that a project would increase the tax base needed to provide a current tax statement and an estimate of future value after the improvements were completed.[17] The better, but more difficult, comparison would have been between value after improvements and what value would have been if the subsidies had not been provided. The property tax values with subsidies would be higher than they would have been without subsidies if the Small Cities Program corrected the private market's failure to fund viable projects.

The staff summaries of proposals noted the number of jobs to be created as the increase in jobs between the time the grant was received and the end of the project.

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[16] "Minnesota Small Cities Economic Development Program Application Manual," especially pages 6, 14, and 21-22.

[17] Ibid., especially page 6.

Staff summaries calculated the ratio of private investment dollars to the program grant.[18] The more accurate way to measure job creation or the effect on private investment would have been to compare the number of jobs or the amount of private investment that existed after the project with the number of jobs or the amount of investment that would have existed if the subsidy had not occurred.

Despite the limited attention to market failure in the application guidelines and the staff assessment, the program could have dealt with market failure, if only by accident. The program's history suggests a mixed record. Table 1 shows the number and percent of firms assisted by the Small Cities Economic Development Program having characteristics that might indicate market failure compared to the percent of firms with those characteristics in the state or some other reference region. The program performed well in funding start-up businesses, doing so at a rate well above the percent of such businesses in the state in a given year. In addition, loans went to businesses in counties that the state legislature termed "distressed" at three times the rate that they went to businesses in other counties.[19] Businesses in economically distressed counties, as measured by especially high unemployment, high poverty rates, or low median incomes, received a higher share of loans than the counties' share of establishments statewide.

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[18] "Private investment" did not, in practice, mean that the funds came from a private source. The calculation of "private investment" often included large amounts of funding from other public sources.

[19] A "distressed" county met criteria set out in Minnesota Statutes, Sec. 297A.257. Counties designated as "economically distressed" in July 1988 either (1) had an unemployment rate over 10 percent for May 1987-April 1988, or (2) had an unemployment rate 10 percent above the statewide unemployment rate and had at least 20 percent of employment in agriculture-related industries (memorandum, Lee W. Munnich to Joe Samargia and Tom Gillaspy, and attachments, July 28, 1988).

Table 1. Establishments Assisted by the Small Cities Economic Development Program with Characteristics Indicating Market Failure

Characteristic	Number Assisted	Percent of Assisted Firms[a]	Percent of Establishments in Comparison Region
Small business, less than 20 employees	84[b]	42.2 (199)	78-87[c]
Start-up business	30	14.7 (204)	4.2-9.8[d]
Female ownership or management	4	1.9 (209)	NA[e]
Female proprietorship or partnership	1	3.4 (29)[f]	31.5[g]
Minority ownership or management	10	4.8 (207)	3.2[h]
Innovating in product or process	15	7.4 (205)	NA
Located in "distressed" county[i]	73	33.3 (219)	10.8[j]
Located in 1/5 of counties with highest unemployment rate[k]	74	33.8 (219)	10.2
Located in 1/5 of counties with highest poverty rate, 1979[l]	42	19.2 (219)	5.5
Located in 1/5 of counties with lowest median income, 1979	41	18.7 (219)	5.1

[a] Data on assisted firms collected from the files of the Small Cities Economic Development Program, Department of Trade and Economic Development, St. Paul, MN. Number of assisted establishments for which information was obtained is in parentheses.

[b] Includes new businesses.

[c] Ernesto C. Venegas, "Understanding Job Growth in Minnesota," Research Paper C, in The Report of the Governor's Commission on the Economic Future of Minnesota (St. Paul: Department of Trade and Economic Development, 1987), p. 97. Number refers to small establishments in Minnesota.

[d] Paul Reynolds and Brenda Miller, 1987 Minnesota New Firms Study: An Exploration of New Firms and Their Economic Contributions, CURA Report 88-1 (Minneapolis: Center for Urban and Regional Affairs, 1988), pp. 15-16, appendix B. Number refers to start-up businesses in Minnesota.

[e] NA means no comparable number available. In this case, recent data are available on female ownership and management for proprietorships and partnerships, not corporations.

[f] Includes only businesses that DTED staff classified as proprietorships or partnerships.

[g] U.S. Small Business Administration, The State of Small Business: A Report of the President Transmitted to the Congress 1989 (Washington, DC: Government Printing Office, 1989), Table A.26. Number is the percent of nonfarm sole proprietorships owned by women in Small Business Administration Region V (Illinois, Indiana, Michigan, Minnesota, Ohio, and Wisconsin) in 1986.

[h] Markham and Associates, "Minority Business Ownership in the Northwest United States," Regional Issues Forum, University of Minnesota, Minneapolis, MN, April 1989, Table 3.

[i] Memorandum, Lee Munnich to Joe Samargia and Tom Gillaspy, and attachments, July 28, 1988. See definition of a distressed county in notes to text.

[j] U.S. Bureau of the Census, County Business Patterns, 1986: Minnesota (Washington, DC: U.S. Government Printing Office, 1988), Table 1e. Number refers to business establishments in 1986 in Minnesota. This is also the source for the percent of Minnesota establishments in counties with other measures of distress.

[k] "State and Area Labor Force Estimates, January 1980-December 1987," Research and Statistics Office, Minnesota Department of Jobs and Training, St. Paul, MN, August 1988 (revised September 1988). Unemployment rate is for the year preceding the application, weighted by grant size when there was more than one grant per county.

[l] Poverty rates and median incomes for counties are from U.S. Bureau of the Census, Census of Population 1980, "General Social and Economic Characteristics," vol. 25, "Minnesota," Tables 71 and 72.

The program financed minority-owned or managed businesses at a rate slightly above that of the percent of minority-run businesses in the state. Minority business ownership in the state fell below the level expected given the minority population of 4 percent in 1980, but the program succeeded in funding businesses at a level comparable to the percent of minorities in the population.

In contrast, the program did poorly in financing small businesses and female-owned or managed businesses. The program funded 84 businesses (including start-ups) with fewer than twenty employees, slightly more than 40 percent of the firms assisted. Because small firms make up approximately 80 percent of businesses in the state, the program funded larger businesses in disproportionate numbers and may have shifted financial resources away from small firms to larger ones. Less than 4 percent of the proprietorships and partnerships that received financing were owned by women, but women owned nearly ten times this percent of proprietorships and partnerships in the region that included Minnesota. Women owned or managed less than 2 percent of all businesses that received program financing. One explanation of why women were virtually left out of the program is that female ownership and management are concentrated in finance, insurance, real estate, wholesaling, retailing, and services--industries that make up only 20 percent of the businesses that received financing from the Small Cities Economic Development Program (see appendix table A-1). Nevertheless, if the program had funded businesses owned or managed by women in the proportion that women proprietors exist in the industries favored by the program, eight or nine times more female-owned or managed businesses would have received funding.[20]

In sum, the Small Cities Program did well in some areas and poorly in others. The program may have stimulated economic growth by dealing with situations where private financing sources were most likely to overlook good investments. However, the program had less effect than might have been possible had more efforts been directed toward dealing with market failure.

Moving businesses into the state or keeping businesses from leaving - Economic growth within a state can result when growth is transferred to the state by moving businesses in or retaining businesses that would have operated elsewhere without the program.[21] The DTED program application instructions stated that applicants could argue that a project would provide necessary "incentive financing"--"a favorable interest rate and term. . .to induce an owner to expand or build a new facility in a community."[22] The manual made no other note of using the program to attract or retain businesses that would have operated outside the state.

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[20] U.S. Small Business Administration, The State of Small Business: A Report of the President Transmitted to the Congress 1989 (Washington, DC: Government Printing Office, 1989), Tables A.26, A.27; files of the Small Cities Economic Development Program.

[21] Although success in attracting a business to the state or retaining one that would have operated outside the state does lead to economic growth, using 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.

[22] "Minnesota Small Cities Economic Development Program Application Manual," pages 7 and 23.

On the other hand, the governor and the commissioner of DEED (predecessor to DTED) emphasized the importance of subsidies in attracting businesses from other states and keeping businesses from moving away. The governor cited Minnesota economic development programs' (including the Small Cities Program's) "hundreds of successes," noting companies that had moved to the state with assistance. The commissioner of DEED stated that Minnesota had to give assistance to retain firms wooed by other states. "That's just the reality of life in the economic development warfare among the states," he said.[23]

What is the Small Cities Economic Development Program's track record in business retention and recruitment? The program rarely caused businesses to locate or remain in Minnesota that would not have done so anyway. Table 2 shows the results of interviews with those who made location and expansion decisions connected with receiving funds from the state. About three-quarters of decision makers considered no location outside the state. The applications filed by local jurisdictions suggested the same, although DTED staff noted that close to one-third of the cases involved "incentive financing," with 17 percent of the subsidies justified by no financial need other than the desire to influence a location decision. Among businesses that considered locations outside the state, almost three in ten decision makers volunteered that the availability of Small Cities Economic Development Program funds were a factor in their location. In

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[23] Rudy Perpich, governor of Minnesota, letter to the editor, St. Paul Pioneer Press Dispatch, 27 August 1987; McDonnell and Thomma, "Economic Development Schooled in Hard Knocks." For other examples, see Mark B. Dayton, commissioner of Minnesota Department of Energy and Economic Development, "State Must Develop New Strategies to Aid Areas in Distress," Minneapolis Star and Tribune, 7 January 1985; "Dayton: State Must Compete for New Businesses," Bemidji Pioneer, 26 September 1985.

Table 2. Relationship of Small Cities Economic Development Program to Business Decisions to Locate or Remain in the State

Evidence	Number	Percent of Decisions
From interviews with decision makers[a]:		
Considered other locations		
- in state(s) bordering Minnesota	18	12.6
- in state(s) not bordering Minnesota	5	3.5
- in state(s) bordering and not bordering Minnesota	12	8.4
- in no other states	108	75.5
Total	143	100.0
Of those considering a site outside the state,		
- volunteered that program funds important in location decision	10	28.6
- did not volunteer that program funds were important	25	71.4
Total	35	100.0
Stated that without program funds,		
- definitely would have done project	8	22.8
- probably would have	1	2.8
- not sure	6	17.1
- probably would not have	8	22.8
- definitely would not have	12	34.3
Total	35	100.0
From applications[b]:		
Considered other locations		
- in state(s) bordering Minnesota	28	14.4
- in state(s) not bordering Minnesota	8	4.1
- in state(s) bordering and not bordering Minnesota	6	3.1
- in another country	2	1.0
- in other state(s) and another country	1	.5
- in no other states	149	76.8
Total	194	100.0
Cited "incentive financing" as important		
- with other financial reasons	19	14.5
- with no other financial reasons	22	16.8
- did not cite "incentive financing" as important	90	68.7
Total	131	100.0

[a] Source is interviews with business decision makers involved in getting Small Cities Economic Development Program funds for their businesses and knowledgeable about location and expansion decisions associated with the funding. Seventy-six other business decision makers were not interviewed because they could not be located, they refused to be interviewed, they could not be reached after repeated tries, or so little information had been obtained about the project that the interviews would not have been useful.

[b] Source is information in the files of the Small Cities Economic Development Program. Totals are less than the total number of business subsidies approved, 219, because files could not be examined in enough detail to address this issue or because no staff summary of the reasons for the need for financing could be located in the files.

addition, nearly 60 percent of those who considered sites outside the state said they would not have gone ahead with the project without the funds.[24] So few businesses considered locations out of the state, however, that only between 7 and 14 percent of the projects DTED approved might have influenced a decision to locate or remain in the state (relying on the number who volunteered that the funds affected their location or on the number who said they would not have gone ahead with the project without the funds).

Achieving Growth in a Community Although Not in the State

To stimulate economic growth in a community, but not necessarily in the state, the program needed to cause activity that would not otherwise have occurred in that particular place.[25] If a business could have found other financing to expand or locate in that place without the program, then the Small Cities Program probably had no effect on the community, for the private funds that the program freed for other uses would probably not also go into the community.[26] For the Small Cities Economic Development Program to increase economic activity in the communities it funded, administrators

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[24] The interview data overstate the importance of the Small Cities Economic Development Program because those interviewed knew that the study concerned the program so they were attuned to think about it and to mention it.

[25] Although the activity might not have taken place in the particular community, DTED's funding of an alternative project could have caused economic growth elsewhere in the state instead. DTED's decisions would have shifted growth around the state, but brought about no additional statewide growth. Therefore, even if a community grew, the state did not necessarily grow also.

[26] A banker in a larger town forty miles away, for instance, would have no reason to assure that the funds he or she would have loaned to the subsidized business went to some other business in the same community. For another example, an individual who would have made a loan to a relative who owned a business that received a subsidy would probably not be inclined to put the same funds into some other business in the community.

needed to assure that a firm had to have the program money to undertake the project and that the project was credit-worthy. Alternatively, the funding needed to cause a business to locate or remain in the community when it would not otherwise have done so.[27]

Filling unmet financing needs of credit-worthy businesses - According to the director, the Small Cities Economic Development Program was to provide "last resort financing." The application instructions emphasized the importance of showing a "financing gap." Applicants were required to document that "all other sources [of financing] have been considered and are not available or are not appropriate." The applicant needed to show that the firm's owners did not have enough equity to invest, the owners could not get enough private financing, the owners could not pay market interest rates or the market terms were unfavorable, the business could not qualify for enough other state and federal financing, "incentive financing" was needed, and/or the cost of public improvements for the project was too high for the owners or the jurisdictions.[28]

Difficulties in finding other financing could also indicate financial trouble and an inviable project. While the application required business financial statements from the previous three years, a current debt schedule, financial projections for the next three

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[27] After jurisdictions received financing for a business and the business repaid the loan, local officials could make new loans to businesses from the revolving loan fund. This evaluation considers only the economic development effects of the initial state agency decision to make a grant to a jurisdiction on behalf of a business, not the effects of recycling the money through the revolving loan fund.

[28] Auger, personal communication, February 1988; "Minnesota Small Cities Economic Development Program Application Manual," pages 14 and 23, attachment III of application in appendix III.

years, and a marketing plan, the assessment of an application included no critique of financial viability. In the only assessment of "financial feasibility," an application received additional points for more private funds invested, for more of all other kinds of funds invested, and for a higher interest rate on the loan from the program grant funds.[29]

At least until mid-1987, state economic development staff did not do the cash flow analysis needed to assess whether a business could undertake the project without the funds or whether a project was viable. Materials in the project files made the process of determining a financing gap seem haphazard. Documentation of financial need appeared in the files for some projects, but not for many others. In two-thirds of the application files examined, business owners and local officials asserted that a financing gap existed but did not provide any proof (see Table 3). More than one-fourth of the application files did not include an administrative summary of financing gap needs. Another researcher who studied the Small Cities Program files concluded that DTED staff looked at whether projects met two of the three state objectives and one of three federal objectives but did not do more thorough analysis to determine if private financing were available. The DTED staff left responsibility to the local jurisdiction for evaluating both the business need and the financial viability of the proposed project.[30]

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[29] "Minnesota Small Cities Economic Development Program Application Manual," pages 14 and 24; Friedman, "Improving Capital Market Efficiency Through State Programs."

[30] Friedman, "Improving Capital Market Efficiency through State Programs."

Table 3. Evidence of a Financing Gap in Businesses Receiving Funds

Evidence	Number (percent)
From interviews with decision makers[a]:	
In trying to get financing the business,	
- looked at some other sources	111 (79.9)
- looked at all other sources	9 (6.5)
- looked at no other sources	19 (13.7)
Total	139 (100.0)
Stated that without program funds,	
- definitely would have done project	23 (16.7)
- probably would have	10 (7.2)
- not sure	24 (17.4)
- probably would not have	32 (23.2)
- definitely would not have	49 (35.5)
Total	138 (100.0)
Of those who probably or definitely would not have done project,	
- looked at some other sources of financing	65 (80.2)
- looked at all other sources	9 (11.1)
- looked at no other sources	7 (8.6)
Total	81 (100.0)
From application files:	
At least one document to demonstrate a financing gap was present	53 (34.6)
No document to demonstrate a gap was present	100 (65.4)
Total	153 (100.0)
Administrative summary sheet on financing gap was present	130 (73.0)
Administrative summary sheet was not present	48 (27.0)
Total	178 (100.0)

[a] See notes to Table 2.

Local staff sometimes did financial analysis of projects, but more often did not. For instance, in the Fergus Falls Port Authority four staff worked on economic development. According to one, everyone had work experience as business consultants or loan officers, and they looked at the same information a bank would to determine whether a business was viable. On the other hand, local officials appeared to rely on minimal financial analysis or rejected signs of problems in Ely, where a project to develop a lodge and convention center languished for years and where another project, approved in 1988, was in financial trouble by fall 1989.[31]

The prospect of getting the initial funding for a revolving loan fund was important in many local efforts to obtain grants through the Small Cities Economic Development Program. The president of one company said that he initially turned down an invitation to apply for financing but changed his mind because "it would really help our town." When Cosmos Enterprises in Elbow Lake received a second Small Cities loan in 1988, many focused not only on benefits from Cosmos' expansion but also on the advantages of the addition to the revolving loan fund. As the economic development director stated, "We fortunately have a company like Cosmos in town which can put together strong development projects to attract [grant] monies." The community development director of the metropolitan suburb Cottage Grove called the Small Cities grant a "win-win" situation. The city got a "nest egg" for a loan fund, and the business received a low-

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[31] Toni O'Brien, staff, Fergus Falls Port Authority, Fergus Falls, Minnesota, personal communication, August 1988; files of the Small Cities Economic Development Program; Jeffrey C. Kummer, "Troubled Project in Ely Foundered on 'Good Faith,'" St. Paul Pioneer Press Dispatch, 10 September 1989.

interest loan.[32] The desire to fund a local revolving loan fund for economic development could have encouraged local officials to look for businesses with good credit, who could get financing elsewhere, but who would also certainly repay the funds to the local loan pool. On the other hand, a jurisdiction could back a business that was not credit-worthy out of "ignorance, excess enthusiasm, or just plain wishful thinking," one researcher concluded.[33] Neither of these possible directions would help the Small Cities Economic Development Program encourage economic growth.

In mid-1987, the federal Department of Housing and Urban Development issued more specific guidelines for determining the presence of a financing gap. The guidelines asked for more analysis of a business's financial position. The new procedures meant DTED staff needed to determine whether a business could proceed without the funding and what the amount and terms of the subsidy should be.[34] The procedures could also have helped in determining whether a project was financially viable.

In mid-1988, despite the new review procedures, the program funded the project of "a financially strapped businessman, a convicted drug dealer and a mysterious Texas mortgage banker," in the words of a St. Paul newspaper reporter. No one had done

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[32] Norman Fey, president, Fey Industries, Edgerton, Minnesota, telephone interview, winter 1989; "City Receives $100,000 Grant/Loan," Grant County Herald, 10 February 1988; "Editorial: Cosmos Connection Works Again," Grant County Herald, 10 February 1988; "Cottage Grove Landed Firm with a Deal," St. Paul Pioneer Press Dispatch, 1 January 1986.

[33] Friedman, "Improving Capital Market Efficiency Through State Programs," page 149.

[34] Cheryl Johnson, Dick Nadeau, and Carol Pressley-Olson, staff for the Small Cities Economic Development Program, DTED, St. Paul, Minnesota, personal communication, December 1988; memorandum, Jack R. Stokvis, general deputy assistant secretary for Community Planning and Development, Department of Housing and Urban Development, to all regional administrators and all category A field office managers, May 19 and June 2, 1987.

routine financial checks. As of fall 1989, the project was in financial difficulty, and its future was uncertain. Robert Benner, Deputy Commissioner for Community Development, stated, "We always assume the people we are dealing with are operating in good faith."[35]

The statements of business managers who made project decisions substantiates the evidence that little assurance existed of financing gaps, although many decision makers stated they would not have undertaken the project without the assistance. Only about 7 percent of decision makers stated that they had exhausted every other financing option. Nearly 14 percent stated they had not looked for financing anywhere else (see Table 3). Although almost 60 percent of decision makers said they probably or certainly would not have undertaken the project without the Small Cities funds,[36] only 11 percent of these said they had looked into every other financing possibility, and more than 8 percent stated they had explored no other financing possibilities.

To stimulate economic activity in a community, the program needed to assure not only that the projects it funded could not have received private financing but also that they were viable. By mid-1989 about 15 percent of the businesses that had received funding from 1984 through late 1988 were not operating. A few of these had never opened; a few others hoped to reopen if their financial difficulties could be resolved.[37]

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[35] Jeffrey C. Kummer, "Troubled Project in Ely Foundered on 'Good Faith,'" and related articles, St. Paul Pioneer Press Dispatch, 10 September 1989; id., "Trade Chief Pledges Closer Scrutiny after Ely Project," St. Paul Pioneer Press Dispatch, 12 September 1989.

[36] These data overstate the importance of the program because decision makers made their statements in response to a direct question about the effects of the program.

[37] Interviews with business decision makers; files of the Small Cities Economic Development Program.

During the same period, many businesses, roughly one-half of 1 percent of all establishments in the state, discontinued operations each year in Minnesota.[38] A higher failure rate would be expected for a program seeking to fund businesses that could not get financing elsewhere, but more careful assessment of business plans and financial statements probably could have reduced the program's rate of business failures.[39]

The Small Cities Economic Development Program did affect the growth of some communities by providing funds for some deserving projects that could not get financing elsewhere. However, careful assessment of businesses rarely occurred, and local officials had numerous reasons to fund either very safe projects that could have obtained financing elsewhere or very risky projects. As a result, the program had less effect on community growth than it could have.

Affecting location decisions within the state - Just as the state could grow as a result of retaining or attracting businesses that would have operated in other states, community economic growth could occur if a jurisdiction used the program to recruit businesses that would have operated in other communities in the state. DTED program staff said they did not intend for the program to work this way. According to the supervisor of the Small Cities Economic Development Program, the program would not assist the "pirating" of a business from another city in the state. It also would not fund a

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[38] Calculation is based on the average annual number of business failures from 1984 through 1988 in Minnesota divided by the number of business establishments in Minnesota in 1986 [Dun and Bradstreet data in Minnesota Economic Resource Group, 1990 Economic Report to the Governor (St. Paul: Minnesota Economic Resource Group, 1990), Table 24; U.S. Bureau of the Census, County Business Patterns, 1986: Minnesota (Washington, D.C.: U.S. Government Printing Office, 1988), Table 1e].

[39] See also, Friedman, "Improving Capital Market Efficiency Through State Programs."

project when that business would compete with other businesses' operations in the state. For instance, the staff rejected an application for funding for a meatpacking and deboning plant, part of an industry facing stagnant demand, because the loan could have displaced jobs in another plant.[40]

Local officials making applications to the Small Cities Program differed from DTED staff over the importance of attracting businesses from other parts of the state. As one local official stated, her agency did not compete with other nearby towns and would not work with a company coming from another town within a sixty mile radius--unless the business's city could not or would not give assistance.[41] Even if all businesses within sixty miles were excluded, most of Minnesota lay outside that range.

What did the DTED staff do to prevent pirating? They asked for assurances that businesses were not using subsidies to move from one location to another within the state. Ninety-five percent of the applications indicated no other location within the state was under consideration.[42] In the case of an application for a "footloose" business that provided mailing services related to coupons, premiums, and contests, DTED asked for evidence that jobs "created" in one location would not be lost in one or two nearby sites. The staff also sought assurances that assistance for a retail or service business would not hurt other local businesses. For instance, when DTED questioned an application for

[40] Auger, personal communication, February 1988.

[41] Local official who has applied for several projects through the Small Cities Economic Development Program, personal communication, August 1988.

[42] This was probably an overstatement because of DTED's position of not funding projects that would move business from one town to another within the state.

assistance for an auto and equipment repair business, the mayor argued that testimony at the public hearing showed a healthier repair shop would generate business for other local firms, and the regional development planner said considerable local unmet demand existed.[43]

In some cases, the staff asked another division of DTED to do "displacement analyses," assessments of the prospects for an industrial sector and the capacity of existing firms in the state to handle future demand. Many of these studies showed that subsidies for a firm would not take business away from other companies, but in the meatpacking example cited by the program's director, the analysis showed that excess capacity existed in the state and the subsidy was not approved. In other instances, however, the staff did approve subsidies in industry sectors where analysis had shown that displacement would occur.[44]

Local officials nevertheless used the program to try to attract businesses from other jurisdictions. In a highly publicized case the city of Blaine used a $250,000 grant from the Small Cities Economic Development Program along with tax-increment financing and creation of an industrial park to persuade NCR-Comten to build a computer assembly plant in Blaine rather than in one of the other northern Twin Cities suburbs competing for the plant. Although the application stated that NCR-Comten might site the plant in South Carolina or in another country, the company officer who dealt with the city and the state later said that because of the desire to be close to the

[43] Files of the Small Cities Economic Development Program.

[44] Office memoranda on displacement analysis, Policy Analysis Division, Department of Trade and Economic Development, 1985-88.

corporate headquarters, also in the northern suburbs, "we never looked outside the state. We would never want to move our headquarters." NCR-Comten ultimately did not use the Small Cities money because the grant required hiring a certain number of workers, a share of them low and moderate income people.[45] In another case, a city's economic development planner said that he saw in a newspaper article that a community was working with a company to resolve problems with a potential expansion site. "We had a site; we had a building about the right size," he said. "On a whim, I contacted them (the company). . . .We stole them from another community."[46]

Despite local officials' recruitment efforts, a small proportion of grants contributed to the growth of a few communities by helping businesses locate in one community rather than another. As Table 4 shows, 80 percent of business decision makers stated they considered no location within the state other than in the community where they located. Of those who did consider other sites in the state, 17 percent volunteered that the funding from the Small Cities Economic Development Program was important in their decision to choose or to remain at that site. Slightly more than 60 percent said they would not have undertaken the activity without the public funds. However, so few considered alternative sites in the state that the program affected the choice only in 3 to 12 percent of cases (relying on the number of those interviewed who volunteered that

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[45] "Suburbs All Roll Out Their Red Carpets for Business," Minneapolis Star and Tribune, 30 January 1986; Ron Henrickson, director of economic development, Blaine, MN, telephone communication, December 1988; "Tale of Two Cities, One Choice Plant," St. Paul Pioneer Press Dispatch, 13 November 1985; "Blaine-NCR Deal in Jeopardy," St. Paul Pioneer Press Dispatch, 5 March 1986; Deets Mittelstadt, NCR-Comten, telephone communication, spring 1989.

[46] Economic development planner, telephone communication, December 1988.

Table 4. Relationship of Small Cities Economic Development Program to Business Decisions to Locate in a Community

Evidence	Number	Percent of Decisions
From interviews with decision makers[a]:		
Considered other locations		
- in the Twin Cities metro area	3	2.1
- outside the Twin Cities metro area	17	11.9
- both inside and outside the Twin Cities area	9	6.3
- in no other areas of the state	114	79.7
Total	143	100.0
Of those who considered another site in the state,		
- volunteered that program funds important in location decision	5	17.2
- did not volunteer that program funds were important	24	82.8
Total	29	100.0
Stated that without program funds,		
- definitely would have done project	4	13.8
- probably would have	1	3.4
- not sure	6	20.7
- probably would not have	9	31.0
- definitely would not have	9	31.0
Total	29	100.0
From applications:		
Considered other locations		
- in the Twin Cities metro area	3	1.6
- outside the Twin Cities area	7	3.6
- both inside and outside the Twin Cities area	0	0.0
- in no other areas of the state	182	94.8
Total	192	100.0

[a] See notes to Table 2.

the public funds were important or on the number who stated the program affected their decision in response to a direct question).

Redistributing Economic Activity

Economic growth can accompany redistribution to less well off places and people, but economic activity can also be redistributed without growth when funds go disproportionately to distressed places and poorer people. To reallocate economic activity to needy communities, more of the funds of the Small Cities Economic Development Program should have gone to distressed areas than to prosperous areas.

Helping distressed areas - The staff of DTED made efforts to distribute the funds to distressed areas by awarding up to 160 of a total possible 600 application points based on certain need-based criteria. Applicants provided information on local unemployment rates, 1979 poverty rates, and 1979 median incomes. If these numbers were greater than the statewide unemployment rate or the 1979 poverty rate, or lower than the 1979 median income, the application received points in the rating system. All applications discussed the community and economic need in detail and described how the project would address this need. DTED staff rated the extent of the community's need based on this narrative.[47] These criteria for demonstrating community need were weak. Most of Minnesota's jurisdictions had unemployment higher than the statewide rate, poverty rates higher than the state poverty rates, and median incomes lower than the state median income because the most populous jurisdictions of the state, the Twin Cities

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[47] "Minnesota Small Cities Economic Development Program Application Manual," pages 21 and 22.

metropolitan area, were the most prosperous. Exactly what constituted "need" was not defined, although DTED offered a list of issues to address in the narrative--"economic vulnerability of the community, events contributing to the depressed economy, unemployment. . ., need to attract or retain essential services, events contributing to a unique situation, number of businesses lost and started in the past three years, infrastructure condition. . ., outmigration due to lack of jobs, opportunity or timeliness to implement project, labor pool needs."[48] The result was that prosperous communities could receive high ratings for need. For instance, an application from Bloomington, one of the twenty fastest growing cities in the Twin Cities metropolitan area between 1985 and 1987, received the second highest possible rating for community need. An application from Cottage Grove, in the county with the second highest median income in the state in 1979, emphasized that a vacant industrial building deterred other businesses from locating in the city's industrial park and a plant closing had cost the city 400 jobs. An application from Rochester, in another county with high 1979 median income, argued that the city was excessively dependent on a few industries, especially health care, and needed the state funding to help reduce its economic vulnerability. An application from Brooklyn Park, where employment grew 25 percent between 1985 and 1987, pointed out that the loss of a business would cost 350 jobs but that the community had been "fortunate" in not losing businesses.[49] Even when a community did not receive points

[48] Ibid., page 21.

[49] Files of the Small Cities Economic Development Program; U.S. Bureau of the Census, Census of Population 1980, "General Social and Economic Characteristics," vol. 25, "Minnesota," Table 180; Regan Carlson, "Employment Trends in the Twin Cities Metropolitan Area, 1980-1987," Publication No. 620-89-044, Metropolitan Council, St. Paul, Minnesota, March 1989, Table 10.

for economic distress, the application could receive enough points from other parts of the application that the proposed project could be approved for funding.

Where did the funds go? As Table 5 shows, the distribution of funds did correlate weakly with regional economic distress. Counties with higher unemployment either for the quarter or the year preceding the application received more funds per capita than counties with lower unemployment. Although correlations of per capita funding with poverty rates and median incomes were weak, they were in the desired direction for dealing with distress. The correlations were sensitive to the results in a few counties; when the three counties with the highest unemployment and the county with the highest per capita funding were excluded, no relationship existed between distress measures and per capita funding.

The distribution of funds per capita for groups of counties arranged by their level of distress helps explain why the correlation between distress measures and funding is weak. If the program distributed funds disproportionately to more distressed areas, per capita funding for the least distressed counties would be very low or zero, and the level of funding would increase steadily or at a more rapid rate as distress became greater.

None of the relationships between distress measures and per capita funding show this kind of pattern. The 20 percent of counties with the lowest unemployment for the year preceding the application received less funds per capita than did the 20 percent of counties with the highest unemployment for the preceding year (see Figure 1). However, for the 60 percent of counties in the middle of the distribution, funding per capita was

Table 5. Correlations Between Per Capita Funds Received in a County and Measures of Economic Distress

Distress Measure	Initial Funds Per Capita[a]	Revised Per Capita
County poverty rate, 1979[b]	.15	.18
County median income, 1979	-.21	-.22
County weighted unemployment rate for year preceding application[c]	.37**	.40**
County weighted unemployment rate for quarter preceding application	.29*	.37**

** = .001 level of significance
* = .01 level of significance

[a] Source is files of the Small Cities Economic Development Program. Revised grants differed from initial grants when a project was cancelled with little money spent or when a jurisdiction received more funds for an ongoing project in an amendment to the first grant. Population data for counties were obtained from the Minnesota Office of the State Demographer, St. Paul, MN.

[b] Poverty rates and median incomes come from U.S. Bureau of the Census, Census of Population 1980, "General Social and Economic Characteristics," vol. 25, "Minnesota," Tables 71 and 72.

[c] Unemployment rates come from "State and Area Labor Force Estimates, January 1980-December 1987," Research and Statistics Office, Minnesota Department of Jobs and Training, St. Paul, MN, August 1988 (revised September 1988); "1988 County Labor Force Estimates (released February 21, 1989)," Research and Statistics Office, Minnesota Department of Jobs and Training, St. Paul, MN, February 1989. Unemployment rates are weighted by the size of the grant where jurisdictions in a county received more than one grant.

not related to distress, although all received more than the counties with the lowest unemployment and less than the counties with the highest unemployment.

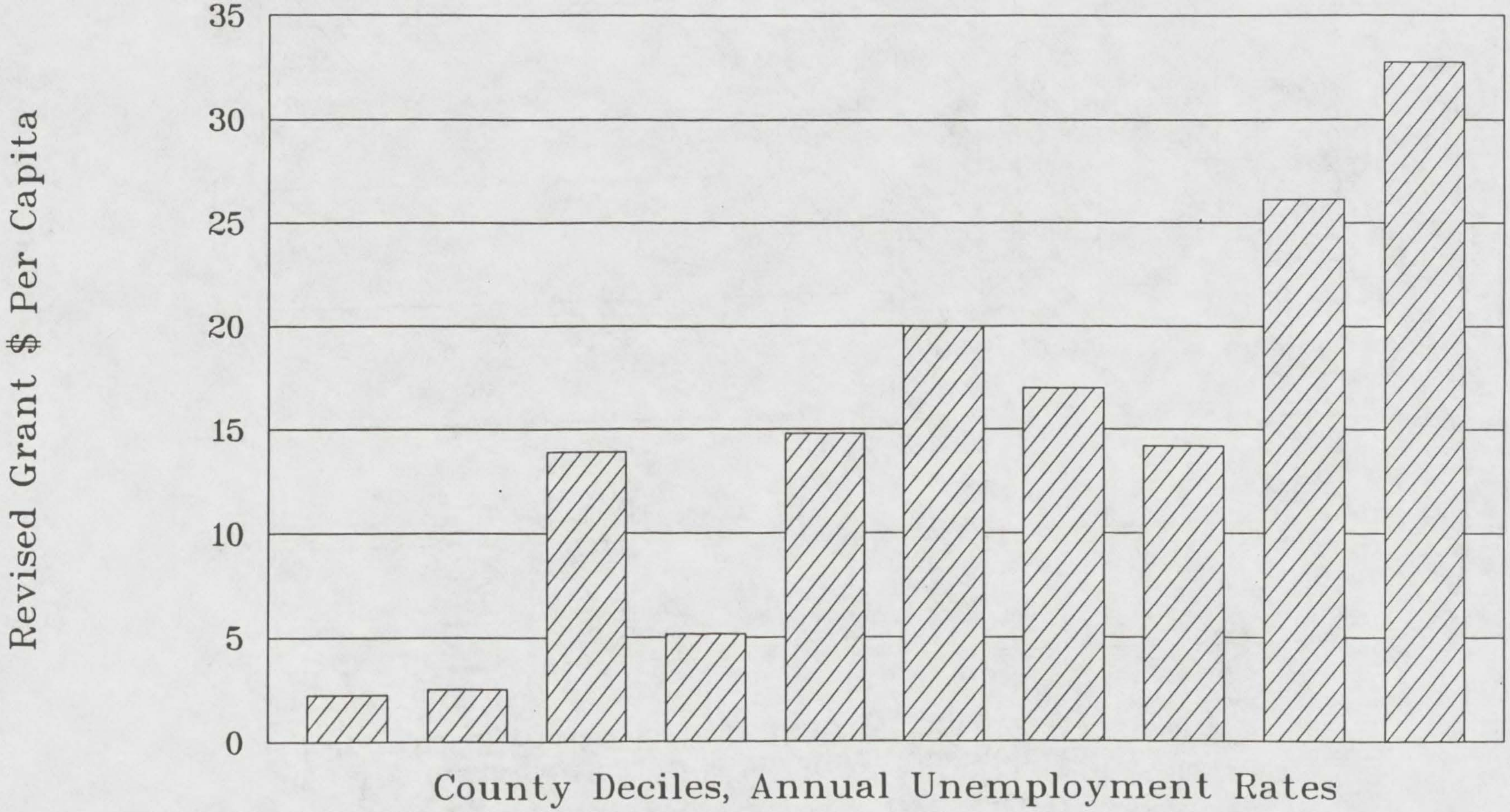
The 20 percent of counties with the lowest unemployment for the quarter preceding the application received less funding per capita than the 20 percent of counties with the highest unemployment for the preceding quarter (see Figure 2). But the 60 percent of counties in the middle of the distribution received erratic amounts of funding.

The relationships between per capita funding and poverty rates and between per capita funding and median incomes were even less consistent with the pattern that would show funds were going to distressed areas of the state. The highest per capita funding went to a group of counties with low, though not the lowest, median incomes in 1979, and the 10 percent of counties with the highest median incomes received the lowest funding per capita (see Figure 3). However, the 10 percent of counties with the second highest median incomes received more funding per capita than any other group of counties except the 10 percent with the second lowest median incomes. The figure shows little relationship between median incomes and per capita funding.

The 20 percent of counties with the highest poverty rates in 1979 received more funding per capita than the 20 percent of counties with the lowest poverty rates (see Figure 4). However, for the 60 percent of counties in the middle of the distribution, little or no relationship existed between per capita funding and poverty rates.

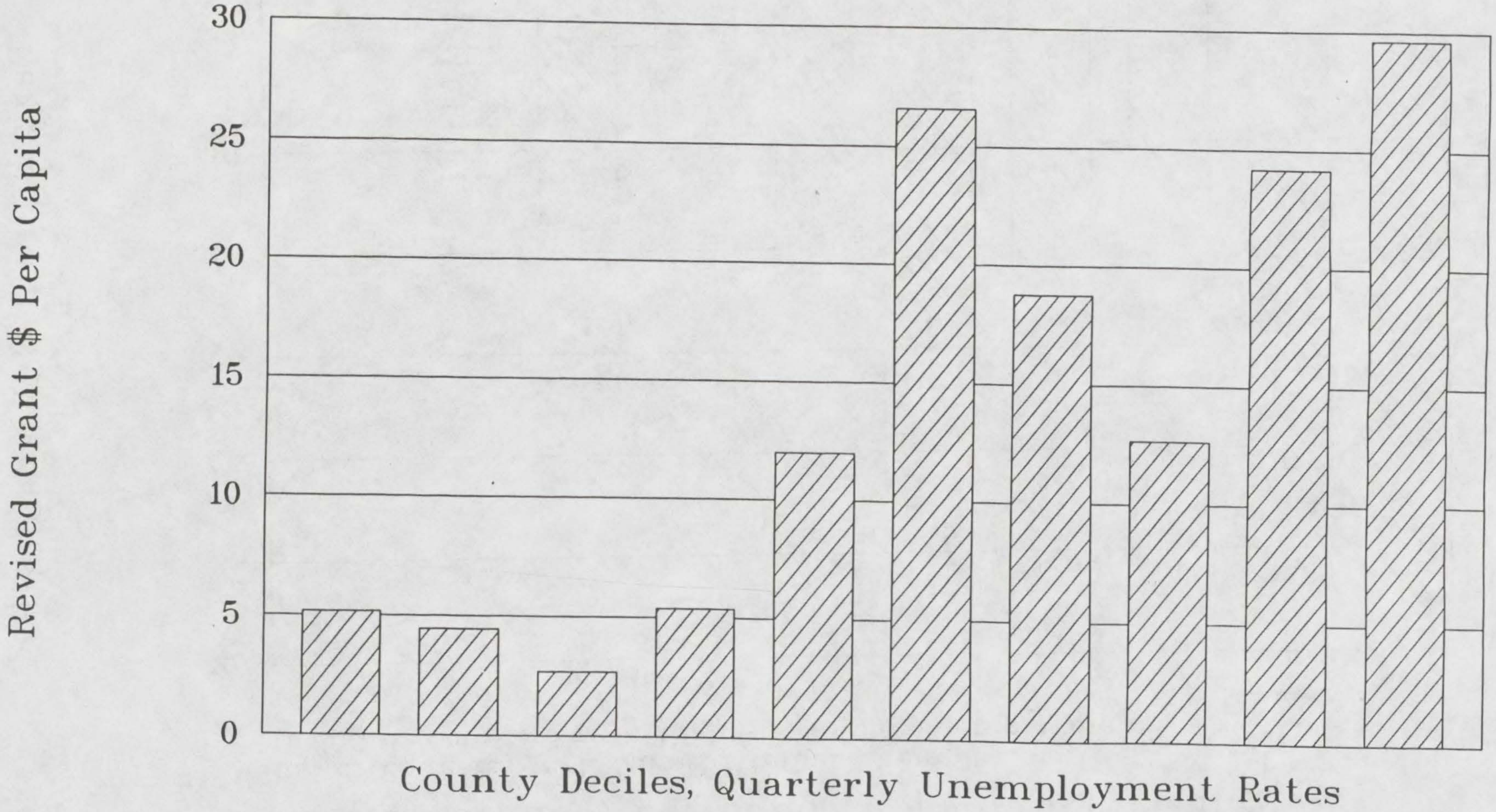
Figure 1
Revised Grant $ Per Capita for County Deciles

10% of Counties with Lowest Annual Unemployment
to 10% of Counties with Highest Annual Unemployment



Unemployment rate for year preceding application

Figure 2
Revised Grant $ Per Capita for County Deciles
10% of Counties with Lowest Quarterly Unemployment
to 10% with Highest Quarterly Unemployment



Unemployment rate for quarter prior to application

Figure 3
Revised Grant $ Per Capita for County Deciles

10% of Counties with Highest Median Income
to 10% with Lowest Median Income

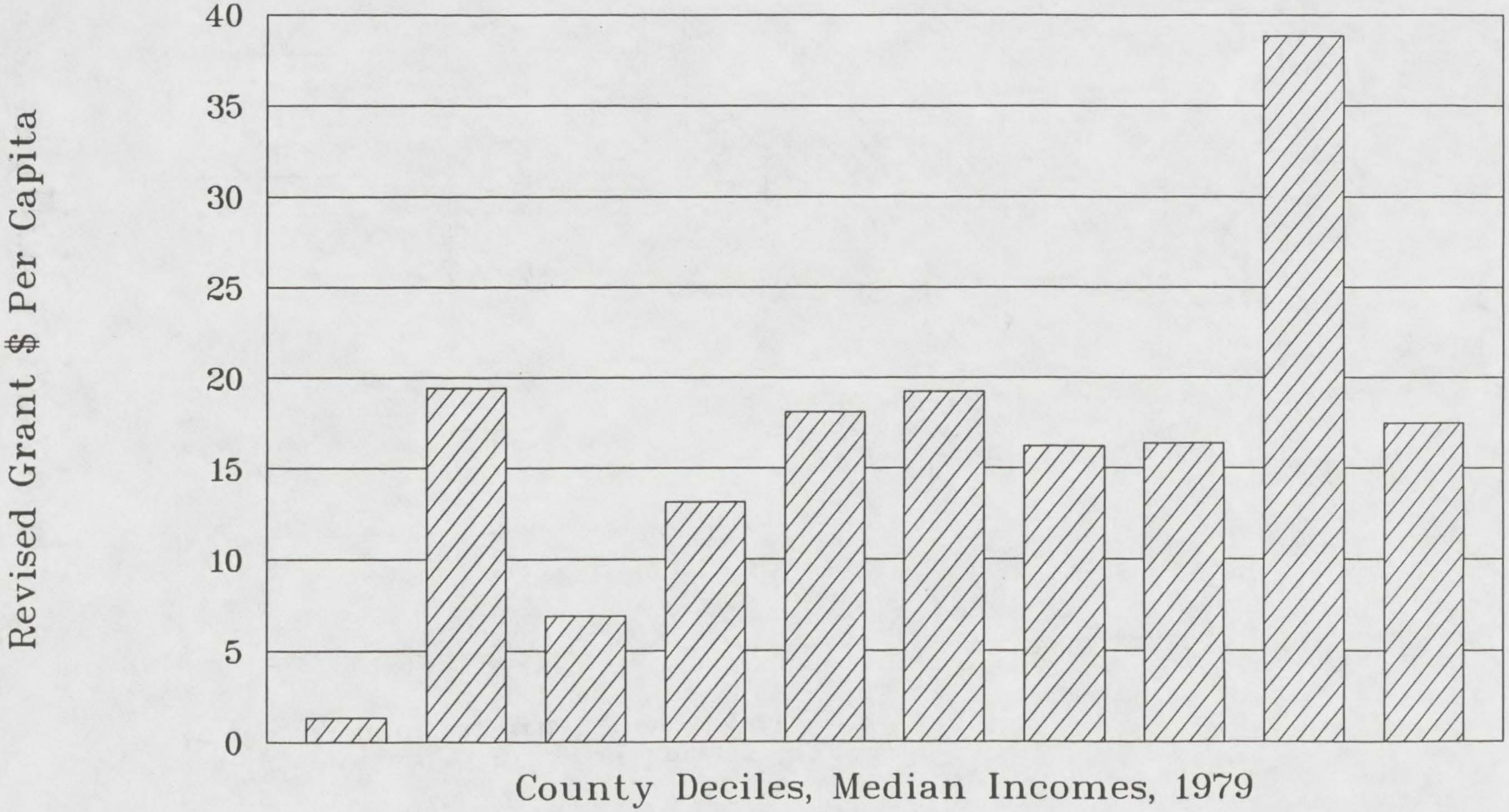
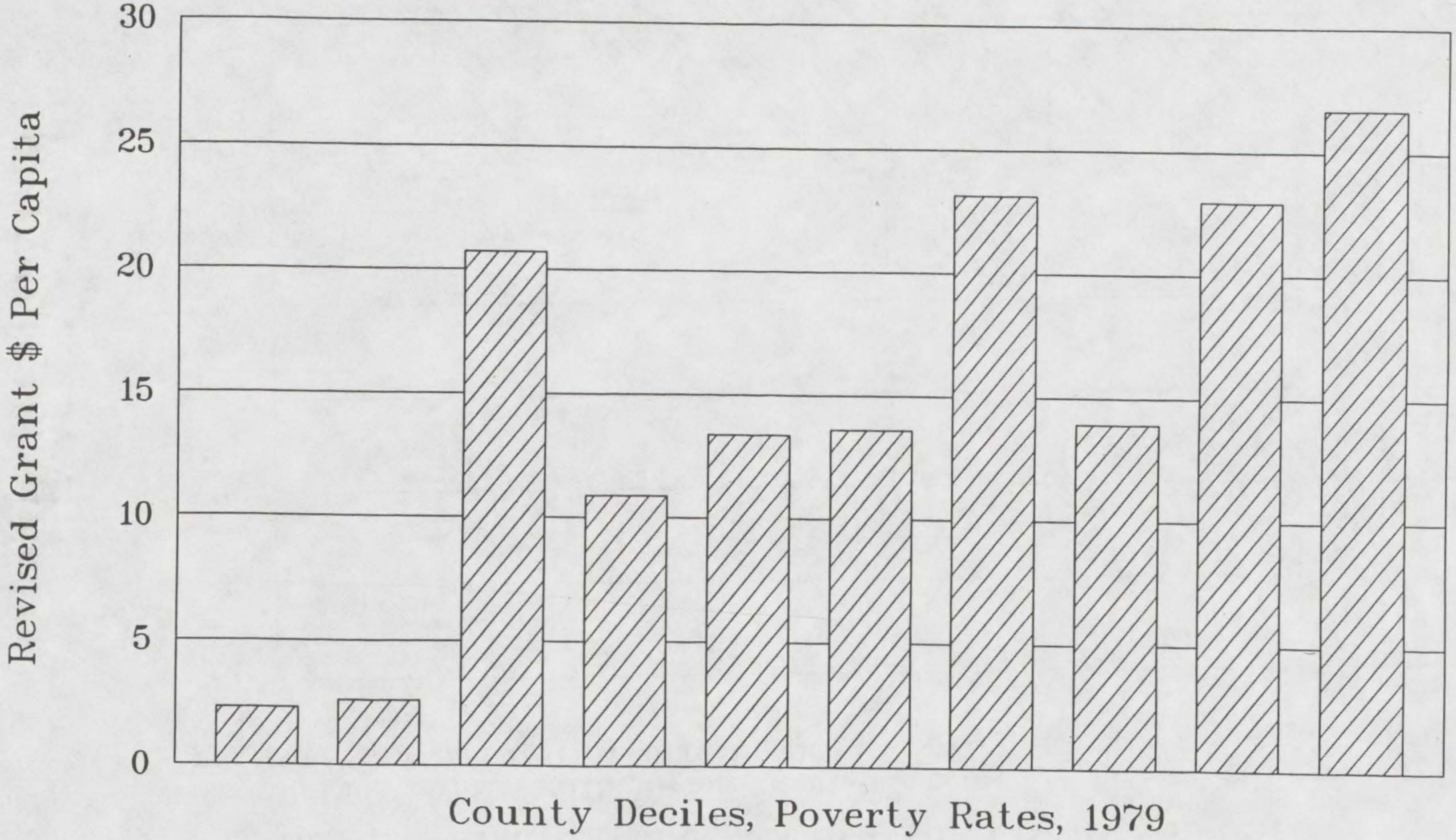


Figure 4
Revised Grant $ Per Capita for County Deciles

10% of Counties with Lowest Poverty
to 10% of Counties with Highest Poverty



Economically distressed counties received smaller grants than the more prosperous counties received. As Table 6 shows, wherever correlations existed between grant size and measures of distress, larger grants were going to better off counties. Counties with higher incomes in 1979 received larger grants. Similarly, counties with lower poverty rates in 1979 initially received larger grants.

Overall, the Small Cities Economic Development Program successfully sent higher levels of funding, measured on a per capita basis, to some distressed counties. Nevertheless, the program could have done much better. For example, the 30 percent of counties with the lowest poverty rates received 42 percent of total program funds; the 50 percent of counties with the lowest poverty rates received nearly 60 percent of the total program funds. A major portion of these funds could have been allocated to more distressed regions.

<u>Benefiting low and moderate income people</u> - Even if the program had a mixed record of directing aid toward distressed counties, the program could have helped low and moderate income people whether they lived in distressed counties or in more prosperous counties.[50] All projects had to meet at least one of the three federal objectives to qualify for funding; almost all applicants chose to benefit low and moderate income people. DTED outlined standards for demonstrating that this objective would be met. Applicants had to show that at least 51 percent of the jobs were for low- and moderate-income people; they had to demonstrate that the retained jobs employed

[50] "Low- and moderate-income" is household income below the Section 8 income limits defined by the federal Department of Housing and Urban Development for counties or metropolitan areas.

Table 6. Correlations of Size of Initial Grants and Revised Grants with Measures of Economic Distress

Distress Measure	Initial Grants[a]	Revised Grants
Used by DTED staff:		
County poverty rate, 1979	-.18*	-.14
County median income, 1979	.23**	.19*
County unemployment rate, quarter preceding application	.01	.06
County unemployment rate, year preceding application	.06	.09
Not used by DTED staff:		
County per capita personal income, preceding year or 1986[b]	-.02	-.03
County average earnings per job, preceding year or 1986	.15	.14
County percent population outmigration, 1984-85[c]	.09	.13
Number of grants is 203		

** = .001 level of significance, 1-tailed
* = .01 level of significance, 1-tailed

[a] See notes to Table 5.

[b] Per capita personal income and average earnings per job are from Bureau of Economic Analysis, U.S. Department of Commerce, Regional Economic Profile data for Minnesota, April 1986.

[c] Migration data are from U.S. Internal Revenue Service, county to county migration flows from administrative records, 1983-84, and 1984-85.

low- and moderate-income people and that new jobs would be filled by or made available to low- and moderate-income people. The applicant provided a list of jobs or job categories, stated how many of these would be for low- and moderate-income people, and explained how the jobs would be made available to low- and moderate-income people. According to the application manual, DTED staff first screened applications to assure they met a federal objective. If they did not, the application would not be reviewed further.[51]

After a project received funding, the local jurisdiction had to show that the jobs had been made available to low- and moderate-income people or that the new employees were members of low- and moderate-income households when they were hired. The jurisdiction submitted quarterly reports listing the jobs created or retained and noting whether the jobs were intended for low- and moderate-income people. The Department of Housing and Urban Development monitored projects funded through the Small Cities Development Program to assure they met the federal objectives.[52]

The program records showed that indeed low and moderate income people were employed or had the opportunity to be hired. An on-site inspection by the Department of Housing and Urban Development concluded that the records accurately reflected businesses' hiring.[53] However, no one was concerned with the quality of the jobs

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[51] "Minnesota Small Cities Economic Development Program Application Manual," pages 5, 13, 17, 65, and 66.

[52] Department of Energy and Economic Development, "Minnesota Small Cities Development Program--Program Manual," St. Paul, MN, 1987, pages 8.5 ff.; memorandum and attachments, Jack R. Stokvis, assistant secretary for Community Planning and Development C, to all regional administrators, all category A field office managers, all regional directors for CPD, and all CPD division directors, regarding response to OIG audit report on economic development in the state CDBG Program, January 26, 1989.

[53] Memorandum and attachments, Stokvis to all regional administrators. . ., January 26, 1989.

promised or delivered, and the jobs were not necessarily good jobs as measured by wage levels, fringe benefits, and promotion possibilities. Indeed, as one DTED staff person wrote in a summary of a project, "The proposed wage scales for the first fifteen employees show a 100 percent benefit to low- and moderate-income persons."[54] Low wage jobs met the federal objective of "benefit" to low- and moderate-income people.

The jobs that businesses promised to provide paid very little (see Table 7). Almost none of the positions, about 1 percent, were to pay the minimum wage. However, close to half of the jobs would have earnings at less than the level defined as poverty for a family of four. Almost two-thirds would pay less than the county average earnings per job for the year preceding the application for funds.

The subsidized businesses delivered jobs that paid even less than they had promised. Only 6 percent paid the minimum wage, but nearly two-thirds of the jobs paid a salary less than the federally defined poverty level. More than 80 percent paid less than the county average earnings per job for the year preceding the application. Because the jobs could be delivered more than two years after an application's approval, average earnings per job rose between the time the jobs were promised and delivered in almost every county.[55] If the salaries and wages paid had kept pace with the change in average earnings over time, delivered jobs would have paid more than promised, rather than less.

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[54] Memorandum regarding City of Elbow Lake Small Cities Economic Development Grant Application, Bob Benner to Mark Dayton, February 17, 1984, in files of the Small Cities Economic Development Program.

[55] U.S. Department of Commerce, Bureau of Economic Analysis, regional economic profile data, unpublished. The increase in earnings was in nominal dollars.

Table 7. Earnings Levels of Jobs Promised and Jobs Delivered in Subsidized Businesses[a]

Level of Salary or Wage in Relation to Comparison Standard	Number of Jobs Promised (percent)	Number of Jobs Delivered (percent)
County average earnings per job for year preceding application[b]:		
At or above	1747 (35.8)	570 (17.3)
Below	3133 (64.2)	2719 (82.7)
Poverty level for family of four, 1987[c]:		
Above	2730 (55.9)	1134 (34.5)
At or below	2150 (44.0)	2155 (65.5)
Minimum wage[d]:		
Above	3873 (79.4)	2808 (85.4)
Equal to	41 (0.8)	205 (6.2)
If wage and hours data missing,		
- salary more than $6968[e]	946 (19.4)	275 (8.4)
- salary less than or equal to $6968	20 (0.4)	1 (0.0)
Total	4880 (100.0)	3289 (100.0)

[a] Data on jobs promised and jobs delivered were collected from the program files in the Department of Trade and Economic Development, St. Paul, MN.

[b] Source is Bureau of Economic Analysis, U.S. Department of Commerce, Regional Economic Profile Data for Minnesota, unpublished.

[c] $11,611 per year. U.S. Congress, House of Representatives, Committee on Ways and Means, Background Material and Data on Programs within the Jurisdiction of the Committee on Ways and Means, 101st Congress, 1st session, March 15, 1989, p. 941.

[d] $3.35 per hour.

[e] Annual earnings for 2080 hours of work at the minimum wage.

The discrepancy between promised and delivered jobs could have existed because lower wage jobs were filled earlier in the lives of projects than higher wage jobs. However, the same pattern existed in subsidized businesses when the projects were complete, where DTED staff had reviewed the project and decided it could be "closed" (see Table 8). Promised jobs were to pay low wages; delivered jobs paid even less with two-thirds of jobs paying below the poverty level for a family of four and more than 80 percent of jobs paying less than the county average earnings per job. Three-fifths of the businesses whose projects had ended paid average earnings lower than they had promised in the application (see Table 9). Although the data on the projects reveal nothing about the situations of the people who held the jobs, many of those people must have remained low and moderate income after they took positions in the subsidized businesses.

Jobs created or retained under the Small Cities Program paid little even though three-quarters of the businesses that received financing were in manufacturing, a sector that pays higher than the average for other sectors in the nation as a whole. The average weekly wage for a job in a manufacturing firm in Minnesota in 1986 was more than $500. Average weekly earnings for a job delivered in a subsidized manufacturing business amounted to slightly over $240.[56]

Similar jobs might have existed without the program. Businesses that would have grown without the program might have paid the same low wages. Unquestionably,

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[56] Minnesota Economic Resource Group, 1990 Economic Report to the Governor, Table 19; files of the Small Cities Economic Development Program.

Table 8. Earnings Levels of Jobs Promised and Jobs Delivered for Completed Projects in Subsidized Businesses[a]

Level of Salary or Wage in Relation to Comparison Standard	Number of Jobs Promised (percent)	Number of Jobs Delivered (percent)
County average earnings per job for year preceding application[b]:		
At or above	488 (33.8)	302 (19.0)
Below	956 (66.2)	1285 (81.0)
Poverty level for family of four, 1987:		
Above	864 (59.8)	543 (34.2)
At or below	580 (40.2)	1044 (65.8)
Minimum wage:		
Above	1204 (83.4)	1336 (84.2)
Equal to	24 (1.7)	142 (8.9)
If wage and hours data missing,		
- salary more than $6968	215 (14.9)	109 (6.9)
- salary less than or equal to $6968	1 (0.1)	0 (0.0)
Total	1444 (100.0)	1587 (100.0)

[a] Data on jobs promised and jobs delivered were collected from the program files in the Department of Trade and Economic Development, St. Paul, MN. Included are projects that were closed and ready to be closed.

[b] For other sources, see notes to Table 7.

Table 9. Number of Businesses with Projects Completed by Relationship Between Average Delivered Earnings Per Job and Average Promised Earnings Per Job[a]

Relationship Between Average Earnings of Delivered and Promised Jobs	Number of Businesses (percent)
Delivered less than promised	25 (61.0)
Delivered equal to promise	4 (9.8)
Delivered greater than promised	12 (29.3)
Total	41 (100.0)

[a] Data were collected from the program files in the Department of Trade and Economic Development, St. Paul, MN.

however, state and local governments were assisting businesses paying low wages, and the growth of such firms lowered average wages in the region. The agency decisions to fund these businesses rather than other businesses and the public decision to use tax receipts to fund these subsidies mean the program may have shifted resources to businesses that pay wages lower than many others in the state. Does this matter? From one perspective, far from "benefiting" people with low- and moderate-incomes, the state has facilitated the pauperization of rural people by subsidizing businesses that pay low wages. Government funds should subsidize good jobs, not ones that assure so many people live close to poverty. From another perspective, by taking the new jobs people have demonstrated that these low wage positions are preferable to their other options. That is, if the program created new jobs in a community, it also improved the choices of people who work there. If people did not want the jobs, the businesses could not find employees at those wages and would have to pay more. Indeed, sometimes the businesses could not fill the low wage positions. One quarterly progress report described a "shortage" of skilled workers because people "can earn more at home on unemployment compensation and AFDC than at (the company)."[57] The owner of a business in Blackduck, located in a county that had a high poverty rate and a low median income in 1979, stated he could not fill jobs although he provided bus service for some workers and a day care center; new employees earned $4 per hour and could make $5 per hour after a year of working at the company.[58]

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[57] Quarterly progress report for East Range Technologies, Aurora, MN, June 30, 1987, in files of the Small Cities Economic Development Program.

[58] Report on Anderson Fabrics, Minnesota Public Radio, St. Paul, MN, spring 1989.

Improving the Record of the Small Cities Economic Development Program

The record of the Small Cities Economic Development Program in encouraging economic growth and bringing about redistribution to more distressed regions and poorer people shows that the program took the right approaches in some ways and not in others. Because of this mixed record, an evaluation controlling for other sources of growth in the state and its distressed areas would probably show, as evaluations have for other programs, few effects on Minnesota's growth or on the growth of distressed areas. An evaluation of improvements in the welfare of poor people would probably show none.

The program administrators could improve the program's record of encouraging economic growth. To do so, they need to redirect the program to deal more effectively with market failure, instances when credit-worthy projects do not receive private financing although comparable projects do receive private support. Reorienting the program to better serve the needs of small businesses and the needs of women who own and manage businesses would increase the chances that the program causes growth. As a result, the program would have a greater likelihood of stimulating private investment, increasing the tax base, and creating new jobs.

If program staff want the program to affect economic growth in the state, they need better assurances that when businesses claim that they need subsidies to stay in Minnesota or to locate in Minnesota, the claims are valid. When a business manager or owner states that the business may leave the state because of higher workers' compensation costs, for instance, program staff need to evaluate how other costs and access to markets will differ in alternative locations. Although a move will reduce workers' compensation, it may raise other costs or cut connections with important customers, so the business is actually unlikely to move. Currently, the program is too likely to use public money to subsidize businesses for doing what they would have done anyway and, therefore, has no effect on economic growth.

To assure that the program is encouraging growth in specific communities, the program staff need to do a more thorough assessment of businesses' financial needs. The DTED staff need to assume this responsibility, for local applicants have many reasons to put forward applications from businesses that have no credit problems or from risky projects that will never succeed. Although the Small Cities Economic Development Program staff have not taken on this responsibility in the past, the record of other, now defunct, state economic development programs and the efforts of some McKnight Initiative Fund offices have demonstrated that the analysis can be done well.[59]

The DTED staff could also improve the program's performance in helping distressed areas and poor people. The application criteria for what constitutes "need" should be clearer, and communities with healthy economies should be excluded from the program. Further, DTED needs to seek more projects in the most distressed areas of the state. The supervisor of the Small Cities Economic Development Program explained that communities initiated applications for businesses; DTED staff did not take leadership in identifying possible projects.[60]

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[59] Friedman, "Improving Capital Market Efficiency Through State Programs;" Leckey, telephone communication, December 1990.

[60] Auger, personal communication, February 1988.

Currently, the program helps low- and moderate-income people principally by subsidizing businesses that offer low wage jobs. The jobs may offer an option that many low wage workers find better than their other choices, as workers demonstrate by filling the jobs. Alternatively, the program could choose to affect fewer people but assist more to escape poverty by assuring that the funds subsidize good jobs. Job quality includes many characteristics not considered here, but at a minimum the jobs would need to pay more than an amount that keeps a household in poverty. The jobs should also offer opportunity for workers to advance to better jobs. Most job training in subsidized businesses was closely tied to the work on the job. Instead, the program could do more to assure that workers receive more general training that would enable them to be more productive in a range of jobs.

To change the way the program works and assure that the changes have desirable effects, the staff need to be able to monitor the program's activities. This means DTED needs a better management information system. For this study, the staff of the community development division provided lists of funded projects with an identification number, the jurisdiction, the business, the amount of funding, the status of the project, and the legislative district. DTED staff stated that, aside from this, no data existed in computer files. Staff cited examples of projects to illustrate points but appeared not to know overall characteristics of projects. Indeed, no one could know the details of so many projects without more data available for computerized analysis.

In 1987 DTED hired the Urban Institute to design a management information system to monitor economic development projects. The proposed system would help with project management, but it would not be useful for assessing whether the program is achieving its stated goals.[61]

These approaches for helping the program achieve its goals are straightforward, but the program staff would still face basic dilemmas in carrying out their charge. The program is to benefit low- and moderate-income people, but its tool is blunt and indirect--a subsidy to a business. This indirect effort to help poor people has led to subsidies to businesses that pay very low wages. The program is to encourage state and local economic growth, but the aims of local officials are sometimes inconsistent with efforts to benefit the state as a whole. Therefore, local officials may seek funds to encourage a business to locate in their town rather than in another or may apply to subsidize a business with no credit problems in order to be sure that the loan is repaid and a local revolving loan fund is created. The program is to deal with community and economic development needs, but the best ways to do so often do not involve subsidizing a business. What subsidies to businesses do best is help the businesses that receive the funds. The inconsistency between community needs and the goal of stimulating economic growth through business subsidies led to funding projects that did not encourage growth or had few community benefits. For instance, DTED financed a project that provided a car wash, a laundromat, and a convenience store partly in response to the community's need for a place where elderly people could walk to wash their clothes. For less than the $50,000 DTED provided, the city officials could have

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[61] Blaine Liner, Urban Institute, to David Speer, commissioner, Department of Trade and Economic Development, and attachments, October 9, 1987; Blaine Liner, Urban Institute, Washington, D.C., telephone communication, winter 1989.

bought washing machines for their elderly residents, but the DTED program would not have allowed this direct solution to the community need.

The changes suggested here may not be difficult, but the federal portion of the program had operated since 1983 and the state portion since 1984 without such changes occurring. During that time, debate over state economic development efforts and studies of economic development programs suggested some of these approaches.[62] Whether such recommendations are reasonable depends on the reasons the program operated as it did over the period studied. A paper that will follow suggests several possible explanations for the results reported here and proposes other recommendations for helping the program achieve its explicit aims based on the understanding of why the program has operated as it has.

[62] Friedman, "Improving Capital Market Efficiency Through State Programs;" Program Evaluation Division, Economic Development (St. Paul: Office of the Legislative Auditor, March 1985). Furthermore, DTED employed staff in the Policy Analysis Office who understood the principles discussed in this paper and sought new ways to help programs achieve their goals (Abigail McKenzie, manager, Economic Analysis Section, and others in the Section, Department of Trade and Economic Development, St. Paul, MN, personal communication, 1985 through 1989).

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Appendix Table A-1. Subsidized Businesses by Industrial Sector

	Number of Assisted Businesses (percent)	Number of Establishments in the state, 1986 (percent)[a]
Agriculture, forestry, fishing	2 (0.9)	1000 (1.0)
Mining	0 (0.0)	169 (0.2)
Construction	0 (0.0)	8986 (8.6)
Manufacturing	167 (76.6)	6826 (6.5)
Transportation, communications, utilities	5 (2.3)	4351 (4.2)
Wholesale trade	12 (5.5)	9141 (8.7)
Retail trade	6 (2.8)	26034 (24.9)
Finance, insurance, real estate	0 (0.0)	8801 (8.4)
Services	30 (13.8)	31845 (30.4)
Unclassified or unknown	1 (0.4)	7568 (7.2)
Total	219 (100.0)[b]	104721 (100.0)

[a] U.S. Bureau of the Census, County Business Patterns, 1986: Minnesota (Washington, DC: U.S. Government Printing Office, 1988), Table 1b.

[b] Column does not sum to 219 or to 100 percent because four businesses fell into two industrial categories.