



## ECONOMIC DEVELOPMENT STRATEGIES, INFORMATION BRIEF 4

# State Financing Incentives for Economic Development

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For businesses large and small looking to start new ventures, expand existing ones, or relocate facilities, access to financing is key. Small businesses and entrepreneurs often need access to credit beyond what their homes and credit cards provide, while large companies look for ways to reduce their costs of financing. Big banks and investors are ready to loan to large businesses, but small businesses rely on local banks that appreciate local conditions. When cost-effective financing is unavailable for worthy projects, state governments can and do step in to help. Governments use their power and pocketbook—often with assistance from federal programs—to reduce risk for banks and investors, helping businesses by increasing access to capital through loans or investment. In some cases, small businesses and startups just need help with planning and marketing to obtain private financing. In return, governments hope the assistance will produce economic growth and jobs in the state.

The goal of state financing programs is to make it easier for new businesses to get start-up money and for existing businesses to expand.<sup>1</sup> While some states have funds to directly invest in companies, many more use programs such as loan guarantees or loan participation to reduce risk for private banks and investors. These tools (table 1) are designed to work in combination for maximum flexibility.

TABLE 1

**Types of Financial Assistance for Economic Development**

Type of assistance	Program	Mechanism
Loan programs	Capital Access	Creates insurance for losses from small business loans.
	Loan participation	Government directly lends a portion of a loan or purchases that portion from the lending bank.
	Loan guarantee	Government cosigns loan, guaranteeing a portion of the loan amount in the event of default.
	Collateral support	Government funds boost collateral for loans.
	Direct loans	Governments loan directly to companies.
Tax-exempt financing	Private activity bonds	Businesses participate in tax-exempt bond issues.
Investment programs	Direct investment	Government provides funds for direct investment in local companies.
	Fund of funds	Government provides funds for local private equity and venture capital funds.
	Certified Capital Companies	Incentive for insurance companies to invest in local private equity funds.
	Investor incentives	Incentives to individuals for local seed capital investing.

Although there are common types of programs, the parameters vary by state, reflecting each state's economic development strategy. Some states use loan assistance programs characterized by limited government intrusion; others prefer the hands-on approach of equity investing. Different states may target different industries or types and sizes of business. For example, Alaska has a loan assistance program specifically for commercial fisheries while Minnesota offers short-term loans to small businesses affected by military reserve call-ups.<sup>2</sup>

## Loan Programs

### Capital Access Programs

Twenty-seven states use Capital Access Programs to increase access to capital by creating a "loss reserve" fund that acts as insurance and allows banks to make loans they otherwise would not.<sup>3</sup> In a typical program, the lender and the borrower each pay a fee between 2 and 7 percent of the loan. The fees are then matched by the state and deposited into an account with the lender.

As more loans are made and more fees are generated, the reserve fund becomes an effective backstop for the bank in case of default. The CalCAP program administered by the California Pollution Control Financing Authority reported that the program made 3,491 loans for a total of \$247 million in 2014, generating \$40 million in fee revenue to the loss reserve funds. The agency approved 143 lender claims for reimbursement totaling \$3.8 million (California Capital Access Program 2015).

The success of a Capital Access Program hinges on banks signing up to be certified lenders. A treasury report on best practices using the funds made available by the federal State Small Business Credit Initiative (SSBCI), created by the Small Business Jobs Act of 2010, showed that states initially

allocated \$291 million to Capital Access Programs, but lack of interest among banks caused over \$250 million to be reallocated to other programs (State Small Business Credit Initiative 2015). After two years, Washington State approved only four loans despite marketing the program and encouraging banks to participate. The state redirected the SSBCI funds to a different loan program.<sup>4</sup>

## Loan Participation

In 39 states, the government may participate in loans with local banks to increase access to financing for small businesses and start-up companies. There are two ways to structure the program. First, the state may directly lend a portion of loan in partnership with a bank that participates in the program (US Department of the Treasury 2011b). If a company needs to borrow \$100,000 for an expansion, a participating bank may decide to lend \$80,000 and ask the government entity to lend the balance. The state could offer a below-market rate as an additional incentive.

The state may also purchase a share of the loan from the bank. Using the example above, the bank loans the business \$100,000 but sells 20 percent of the loan to the state. One advantage for the state is the bank conducts the negotiation and underwriting necessary for the transaction.

## Loan Guarantee

State governments may also guarantee loans in case of default. In many states, loan guarantees are backed up by reserve funds administered by the state, similar to Capital Access Programs, but can also be only a promise to guarantee. New Hampshire's Working Capital Loan Guarantee program is backed not by a reserve fund but by the "full faith and credit" of the state.<sup>5</sup> A loan guarantee program can be designed to cost the government money only in default. While most states cap the amount they will guarantee, monitoring is required to be sure that the state has a diverse portfolio and is not overexposed to a single company. In Rhode Island, the state used half of a loan guarantee program's funds on a single company that defaulted, costing the state \$75 million.<sup>6</sup>

## Collateral Support

One way banks ensure repayment is by requiring collateral, such as inventory or equipment, to be pledged by a business. If a business does not have sufficient collateral, there may be a state program that fills the gap to secure the loan. The bank then has an assurance of receiving some of its principal back in the case of default. This can effectively promote economic development without directly investing funds. However, the potential exists for unexpected drawdowns on the collateral. States usually set these programs up with a one-time appropriation that can be leveraged.

## Direct Loans

Very few states offer direct loans to private companies that have trouble getting financing from conventional sources. Typically, the loans are made to small businesses and in small amounts. The New Jersey Economic Development Authority receives both state and federal grants to operate a direct loan

program that also requires job creation. The payments from these loans are kept by the agency to lend out again (New Jersey Economic Development Authority 2015). This method of providing assistance is attractive because the entity can be funded from state and federal grants, other programs, and the recapture of the loan principal plus interest. Even so, direct loan programs are less popular than loan assistance programs in part because banks are better positioned to evaluate a small business' need and ability to repay the loan than an economic development agency.

## Tax-Exempt Financing

### Private Activity Bonds

Private activity bonds are special, tax-exempt bonds issued by state agencies for private purposes.<sup>7</sup> States receive an allocation from the federal government for the type of private activity bonds that are commonly used for economic development purposes.<sup>8</sup> These bonds are issued by government entities authorized by the state government and paid back by payments from the beneficiaries. The Michigan Strategic Fund issues the bonds and can loan the proceeds to manufacturers to acquire land, building, and equipment directly related to the manufacturing process—excluding warehouse space (Michigan Economic Development Corporation 2015). States use their allocation differently; some use it primarily for housing projects while others like Michigan incorporate the bonds into their economic development strategy.

Every state has a cap on how many bonds it can issue annually, based on population.<sup>9</sup> Interest income to bondholders is exempt from federal tax and often exempt from state tax for in-state-issued bonds. In 2013, long-term private activity bonds totaled \$81.4 billion, including refunding bonds used to pay off higher-rate issues.<sup>10</sup>

## Investment Programs

### Direct Investment

Many states have established venture capital or seed capital funds to invest actively or passively in specific companies. These funds, increasingly popular over the last decade, have a dual mandate of generating returns and investing only in local companies. States invest directly or through a fund run by an outside investment manager that specializes in local companies. Connecticut's Eli Whitney fund, named for the inventor of the cotton gin, makes early-stage direct investments up to \$1.5 million per round in a single local business. The fund currently has \$61 million invested.<sup>11</sup>

### Fund of Funds

An indirect approach is to invest using a fund of funds approach. The state's money is invested in private fund instruments and leverages funds from other venture capitalists and investors. The advantage is

that the state's investment capital can be invested in a broader array of companies than with a direct investment, though the money is less targeted and may largely be replacing private investment in projects that would have received funding regardless. These programs protect the state's capital, can earn higher returns than other investments, and can signal to outside investors the state's interest in developing specific types of businesses.

## Certified Capital Company

Certified Capital Company investment programs are a form of venture capital funding active in seven states—Alabama, Colorado, Florida, Missouri, New York, Texas, and Wisconsin—and Washington, DC. These programs are designed to use the large assets held by insurance companies for local business investment. The state offers an insurance premium tax credit for insurance companies that place funds with local venture capital funds. The private equity funds then invest in local companies to create jobs and income in the state. These programs have stirred controversy after a series of audits in different states showed that most of the money was not invested in local small businesses but instead in safe, low-risk investments—and fees for fund managers.<sup>12</sup> Insurance companies profited, getting their money back plus the tax credit and interest. The fund managers were also winners, mainly through fees, but the states lost the tax revenue and got very little in the way of local investment.

## Investor Incentives

Twenty-nine states use incentives for individual angel investors as an indirect way to assist with financing. This is primarily accomplished with tax credits for angel investments (Francis 2014). The theory is that if the state subsidizes some of the risk, more investments will be made locally by sophisticated investors. These credits have been cited anecdotally as important to start-ups, but there is little data to determine real effectiveness, as it is difficult to identify investments that would not have been made absent the credit.<sup>13</sup> Bell, Wilbanks, and Hendon (2013) show an increase in entrepreneurial activity following the introduction of an angel credit, but others suggest the credit is unnecessary.<sup>14</sup>

The New Markets Tax Credit program encourages investment in low-income areas by providing tax credits to private investors through certified Community Development Entities that invest in businesses and real estate projects for economic and community development purposes (Abravanel et al. 2013). The Community Develop Entity is a private entity (most commonly a bank), but in some states it is controlled by a quasi-public entity whose mission is economic development.<sup>15</sup>

## Conclusion

Effective and efficient financing is crucial to starting, maintaining, and expanding a business. State efforts to increase access to capital markets for local business nurture a vibrant economy, while state programs to finance large-scale investment are incentives to relocate. Economic development agencies at all levels realize this and incorporate these programs into their economic development strategy. Unlike tax incentives, the program funds can be reinvested when businesses pay back the principal for

loan programs or have a successful exit in equity programs, making financing assistance programs attractive to policymakers.

Some of the more popular grant programs for economic development goals help small companies with product development and marketing, or patent holders with technology commercialization, positioning promising companies to obtain private financing. Colorado's Advanced Industry Accelerator program provides grants to assist "proof of concept" work for technologies developed at the state's research institutions.<sup>16</sup> California, Delaware, Maryland, New Hampshire, Pennsylvania, and Utah also have technology commercialization grant programs.

As with any program that diverts public money for private purposes, adequate monitoring and due diligence are necessary. Programs where the state guarantees loans rather than owning a portion or providing collateral must be continually monitored to avoid overextension, where reserves are inadequate to backstop defaults, and surprise calls on state revenue.

## Notes

1. Omitted from this discussion are targeted financing assistance programs that address inequities in financing (as opposed to insufficient financing) for businesses owned by minorities, women, veterans, and so on.
2. See "Loan Programs," Alaska Department of Commerce, accessed February 18, 2016, <https://www.commerce.alaska.gov/web/ded/FIN/LoanPrograms/FisheriesEnhancement.aspx>; and "Minnesota Reservist and Veteran Business Loan Program," Minnesota Department of Employment and Economic Development, accessed February 18, 2016, <http://mn.gov/deed/business/financing-business/deed-programs/mn-reservists.jsp>.
3. The US Treasury manages the State Small Business Credit Initiative and has prepared reports on state programs, including Capital Access Programs (US Department of the Treasury 2011a).
4. Email exchange with Jane Swanson, Business Loan Programs Manager, Washington State Department of Commerce Business Services Division, February 3, 2016.
5. N.H. Rev. Stat. 162-A:13-a. "Working Capital Loan Guarantee Program." <http://www.gencourt.state.nh.us/rsa/html/XII/162-A/162-A-13-a.htm>.
6. Tim White, "State Investigators Have Begun Interviewing Lawmakers on 38 Studios," *WPRI.com Eyewitness News*, July 3, 2014, <http://wpri.com/2014/07/03/state-investigators-have-begun-interviewing-lawmakers-on-38-studios/>.
7. Detailed statistics and descriptions of tax-exempt bonds available from the Office of Tax-Exempt Bonds (2016) and at "SOI Tax Stats - Tax Exempt Bond Statistics," Internal Revenue Service, last updated November 18, 2015, <https://www.irs.gov/uac/SOI-Tax-Stats-Tax-Exempt-Bond-Statistics>.
8. There is a class of purposes that can be financed outside of the allocation caps.
9. U26 I.R.C. § 146 (2015). <https://www.law.cornell.edu/uscode/text/26/146#>.
10. IRS, Statistics of Income Division, Tax-Exempt Bonds, September 2015 Table 10. <https://www.irs.gov/uac/SOI-Tax-Stats-Tax-Exempt-Bond-Statistics>.
11. See "Eli Whitney Equity Fund," Connecticut Innovations, accessed February 18, 2016, <http://ctinnovations.com/funding/eliwhitney>; and Connecticut Innovations, Incorporated (2015). Note: a "round" refers to a solicitation for investment and is also referred to as a "series."
12. See Cromwell and Schmisser (2015) for critique of state programs. For detailed state analyses, see Office of the District of Columbia Auditor (2009); State of Louisiana Legislative Auditor (2001); and Kathleen Gallagher

- and Mark Johnson, "Financial Firm Kept Nearly Half of State's CAPCO Investment," *Milwaukee, Wisconsin Journal Sentinel*, October 8, 2011, <http://www.jsonline.com/watchdog/watchdogreports/financial-firm-kept-nearly-half-of-states-capco-investment-131400693.html>; S. V. Dáte, "Nothing Ventured, Millions Gained," *Palm Beach Post*, May 22, 2003.
13. See Olofsson (2011) and Hayter (2008) for reviews of angel investor credits. Also see J. Patrick Coolican, "Angel Investment Tax Credit Pricey but Has Defenders," *Minnesota Star Tribune*, October 31, 2015. <http://www.startribune.com/angel-investment-tax-credit-pricey-but-has-defenders/339131951/>.
  14. Scott Shane, "The Problem with Tax Credits for Angel Investors," *Bloomberg Businessweek*, August 20, 2010. [http://www.businessweek.com/smallbiz/content/aug2010/sb20100820\\_461551.htm](http://www.businessweek.com/smallbiz/content/aug2010/sb20100820_461551.htm).
  15. For example, the New Mexico Finance Authority co-owns Finance NM, LLC, a private community development entity that administers new market tax credits. See "New Markets Tax Credits," New Mexico Finance Authority, accessed February 18, 2016, <http://www.nmfa.net/financing/new-markets-tax-credits/>.
  16. See "Advanced Industries Accelerator Grants," Colorado Office of Economic Development and International Trade, accessed February 18, 2016, <http://www.advancecolorado.com/funding-incentives/advanced-industries-accelerator-grants>.

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## About the Economic Development Strategies Project

The Economic Development Strategies project is a three-year project to assemble comprehensive research on state economic development strategies. The scope of the project goes beyond financing programs discussed here to include tax incentives, workforce development, and best practices. This is the fourth of eight informational briefs that will frame the project.

## About the Author



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