South Dakota's Economic Development Loan Fund--Ten Years Later

Introduction

During the 1987 Legislative Session a revolving loan fund was created to provide low interest loans for economic development. This issue memorandum will explain how the revolving loan fund got started, detail the loan application procedure, review some statistics that relate to the revolving loan fund's performance, and briefly discuss the future of economic development.

Background

During the State of the State address to the 1987 Legislature, former Governor George S. Mickelson said that the major challenge and most critical need facing South Dakota was the development of our economy and jobs. To address this issue, the Governor proposed and the Legislature approved a capital fund for economic development. This fund is known as the Revolving Economic Development and Initiative (REDI) Fund.

The initial capital for the REDI Fund came from a temporary one cent increase in the state sales tax. The temporary one cent sales tax increase became effective on May 1, 1987, and was repealed on February 29, 1988. The temporary tax raised approximately $40,000,000, which was deposited in the REDI Fund.

The Board of Economic Development was also created during the 1987 Legislative Session and given authority to promulgate administrative rules to make loans from the REDI fund and establish criteria for application, qualification, payment, and repayment of loans. The Governor may appoint up to thirteen members to the board. The statutes governing the REDI Fund may be found in chapter 1-16G of the South Dakota Codified Laws. The administrative rules governing the Board of Economic Development may be found in article 68:02 of the Administrative Rules of South Dakota.

According to § 1-16G-3 of the South Dakota Codified Laws, the purpose of the REDI Fund is to make loans for economic development. The REDI Fund was established to help companies create primary jobs, increase capital investment, and diversify the state's economy. Primary jobs are defined in administrative rule as "Jobs that provide goods and services which are primarily exported from the state, that gain market share from imports to the state, or that meet an unmet need in the area and result in the creation of new wealth. Primary jobs are derived from businesses that bring new income into an area, stimulate other local businesses, or assist a community to diversify and stabilize its economy."

In the area of economic diversification, an early goal of the REDI Fund was to increase economic activity in sectors other than agriculture and to provide more non-farm employment opportunities. There were two reasons for concentrating on non-farm employment opportunities. First, South Dakota's economy depends heavily on agriculture. When the agricultural economy experiences a downturn, the negative effect is felt more acutely due to the heavy reliance on agriculture by other sectors of the economy. Second, the trend in South Dakota Agriculture is farms that are fewer in number but larger in size. In order to retain those who are displaced from farms, non-farm employment opportunities need to be created in small South Dakota communities.[1]

When the REDI Fund was established, it was the state's primary financial incentive to encourage companies to relocate in South Dakota. The REDI Fund also provides financial incentive for new start-up companies and for existing companies looking to expand. The principal mission of the REDI Fund is to create incentives for the creation of quality jobs in South Dakota.[2]

South Dakota's economic development program was built on a foundation of education as reflected in the following quote from the Board of Economic Development's 1988 Annual Report:

> The Governor's [George S. Mickelson's] commitment to education insures that we will continue to provide the quality of employees that companies will need in the future. Governor Mickelson firmly believes our education system is directly related to our future economic development success. Economic development in South Dakota must be built on a firm foundation--a foundation that begins with well-trained, fairly paid teachers and ends with well-educated high school, vocational, and college graduates who can find satisfying work in South Dakota.
>
> Education is crucial to economic success. Through the use of the Future Fund, also created in 1987, Governor Mickelson strongly supports partnerships with vocational schools, colleges, universities, and industry to move our state forward. Institutions of higher learning must communicate and cooperate with business if graduates are to have

the skills demanded in the workplace. A strong educational system producing well-trained graduates will attract businesses that can provide challenging employment for South Dakota graduates.

The Future Fund was also a component of Governor Mickelson's 1987 economic development plan for South Dakota. The revenue for the Future Fund comes from a portion of the money paid by employers for unemployment compensation. The annual revenue is approximately $5,000,000 to $6,000,000. The money in the Future Fund is appropriated in the budget of the Governor's Office of Economic Development. Section 61-5-24.2 of the South Dakota Codified Laws creates the Future Fund and requires that the fund be used for purposes related to research and economic development.

Loan Eligibility and Application

Any for-profit business or nonprofit business cooperative that is either a start-up business, an existing business, or the relocation of an existing business from out-of-state which will create new primary jobs in South Dakota is eligible to apply for a loan from the REDI Fund. The Governor's Office of Economic Development provides application forms.

An applicant may not apply for a loan for more than 50 percent of the total project costs. The maximum loan amount is $1,000,000 unless the applicant includes a petition claiming the project's significant economic development or job creation impact. The Board of Economic Development must approve the petition by majority vote before processing the application. The applicant must provide an equity contribution of at least 10 percent of the total project costs unless waived by a two-thirds vote of the Board of Economic Development.

REDI Fund loans may be used for the following purposes: purchase land; construct or acquire buildings; purchase and install machinery and equipment; construction fees, services, and costs; and other purposes approved by the Board of Economic Development. Loans may not be used to finance or refinance existing debt or for the preliminary design stage.

The Board of Economic Development considers a number of factors when making a decision on an application. These factors are listed in the administrative rules. Some of the factors are number of primary jobs created; amount of the loan; the project's economic and environmental impact on the community, area, and state; the payroll and benefit structure; the potential success of the business; ability to repay the loan; and economic feasibility, to name a few.

When a loan is approved, the Board of Economic Development and the borrower execute a loan agreement. The agreement contains the rights and responsibilities of the parties and the terms and conditions of the loan. Loans typically mature after five years with payments amortized over not more than twenty years. A balloon payment is made at the end of the fifth year. The Board of Economic Development sets the interest rate, which has typically been around five percent.

If a borrower defaults on a loan agreement the Board of Economic Development may place the borrower in default. Upon default, the board may declare the loan due and payable, take title by foreclosure, or take any other action considered appropriate by the board to protect its interest.

The Administrative Rules of South Dakota detail all of the rules relating to the REDI Fund in chapter 68:02:01.

Statistical Information

Loans--The first REDI Fund loan was approved by the Board of Economic Development in Fiscal Year (FY) 1988. At the end of FY 1997, the Board of Economic Development had approved 206 loans totaling $81,277,211. The table at the back of this issue memorandum lists all REDI Fund loans (by county) from September 1987 through June 1997. Approximately seventy percent of REDI Fund loans are for expansion of existing South Dakota companies, while new businesses and company relocations account for nineteen and eleven percent of the loans respectively.[3]

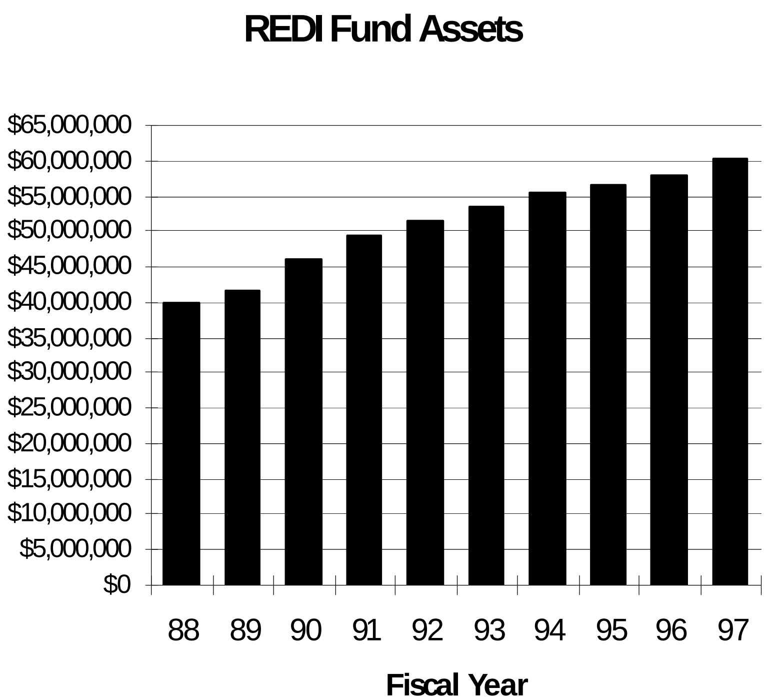
Job Creation--Creating quality jobs continues to be the main focus of the Board of Economic Development. Through FY 1997, the total REDI Fund job creation is 16,642 jobs.[4]

Wages--The average wage for all REDI Fund employees as of June 30, 1997, was $10.90 per hour. Production wages for REDI Fund employees averaged $8.35 per hour.[5] By comparison, the United States Bureau of Labor Statistics reported the 1996 average hourly earnings for the manufacturing industry in South Dakota to be $9.59.

Defaults--The REDI Fund, much like the banking industry, has some loans where the borrower fails to succeed as projected and defaults on the loan. According to the Governor's Office of Economic Development, at the end of FY 1997, the amount charged off from fourteen defaulted loans is $743,903. This amounts to approximately 0.9 percent of the $81,277,211 in loans made from the inception of the fund through the end of FY 1997. This compares with a default rate of 0.2 percent for South Dakota banks during the same time period.[6] The higher loss percentage in the REDI Fund, when compared to the banking industry, may reflect the risk associated to loaning money to start up companies which have a higher failure rate than companies that are expanding operations.

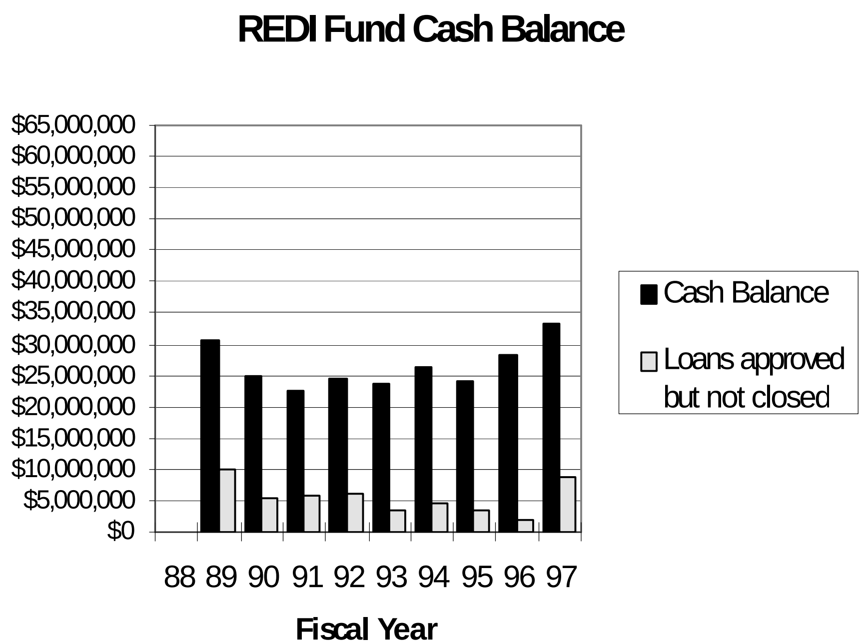
Assets and Cash Balance--The interest from REDI Fund loans and the investment income derived from the REDI Fund cash balance in the State Treasury are both returned to the REDI Fund. The interest and investment income have increased the REDI Fund assets from the initial $40,000,000 generated by the temporary sales tax increase to approximately $60,000,000 on June 30, 1997. Figure 1 shows the REDI Fund assets at the end of each fiscal year.

Figure 1



The cash balance in the REDI Fund at the end of FY 1997 (June 30, 1997) was $33,255,245. The Board of Economic Development had loan commitments (loans that are approved but not yet disbursed) of $8,608,500 at the end of FY 1997. Figure 2 shows the historical cash balance and loan commitments at the end of each fiscal year.

Figure 2



These graphs bring up the policy issue of the size of the REDI Fund. Is there a point where the fund is large enough? The fund has grown from $40,000,000 to $60,000,000 in approximately ten years primarily because of investment income generated by the cash balance in the State Treasury. Over the life of the fund, the net cash balance (cash balance minus loans approved but not closed) has been between $16,000,000 and $26,000,000 at the end of any given fiscal year.

The Future of Economic Development

How will states carry on economic development in the years ahead? We know that the past ten to twenty years have resulted in states expanding their economic development efforts through loan funds and tax incentives that are used to recruit new businesses, encourage existing companies to expand, and help new companies get started. States have even engaged in bidding wars with each other in an effort to get a company to locate in a state. By 1996, more than forty states offered some form of business incentive (e.g., low interest loans) and tax incentive to encourage economic development within a state. According to a survey by the Council of State

Governments, it appears that states will maintain their incentive activities at current levels over the next five years.[7]

How effective are these business and tax incentives? Proponents believe these economic development tools have a positive effect on business location decisions. Opponents maintain that these business and tax incentives are not the primary factors in a business location decision and that the incentives take money from other public services. Policymakers are beginning to evaluate the effectiveness and performance of the economic development tools. For example, in 1995 the Pennsylvania General Assembly evaluated all of the state's economic development programs to determine fiscal accountability and program effectiveness. By evaluating the current program, a state may be able to give future direction to its economic development program.

Dakota Pork Update

In August of 1997, Dakota Pork Industries in Huron closed its meat processing plant. The closed plant was then sold to Smithfield Foods, Inc., and has not been reopened. At the time the plant was closed, Dakota Pork Industries had two outstanding loans from the REDI Fund with a total balance of approximately $1,100,000. On September 24, 1997, these two loans were paid.

Summary

The REDI Fund has provided low interest loans for economic development for approximately ten years. The loans have helped existing companies expand, created new businesses, and helped companies relocate to South Dakota. The REDI Fund assets have grown from the initial $40,000,000 to approximately $60,000,000 at the end of FY 1997. This growth is primarily attributed to investment income from the fund's cash balance that is in the State Treasury. While states will likely maintain economic development activities at their current levels over the next five years, policymakers have started to review and evaluate the performance of economic development activities.

This issue memorandum was written by David Becker, Senior Fiscal Analyst for the Legislative Research Council. It is designed to supply background information on the subject and is not a policy statement made by the Legislative Research Council.

[1.] Governor George S. Mickelson's Revolving Economic Development Initiative Fund Report (REDI FUND, 1987.) January 1988.

[2.] South Dakota Board of Economic Development, Annual Report to Governor George S. Mickelson and the Members of the South Dakota Legislature. September 1, 1988.
[3.] South Dakota Board of Economic Development, Revolving Economic Development Initiative (REDI) Fund Annual Report. 1997.
[4.] *Ibid*.
[5.] *Ibid*.
[6.] Telephone conversation with staff at the South Dakota Division of Banking, October 2, 1997.
[7.] Chi, Keon S. and Drew Leatherby, State Business Incentives: Trends and Options for the Future. Council of State Governments. 1997.