STATEMENT OF ROBERT D. REISCHAUER
DEPUTY DIRECTOR
CONGRESSIONAL BUDGET OFFICE

BEFORE THE
COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS
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In response to the continuing economic problems of distressed urban and rural communities, the Administration recently proposed a major increase in funding for the Economic Development Administration's (EDA) business development program—Title III of the EDA legislation. The current request for $569 million of budget authority for these programs represents a 171 percent increase over the amount in the Administration's original fiscal year 1980 budget proposal and the loan guarantee authority request of $1.8 billion represents a 324 percent increase over the original budget proposal. These requests are also substantially higher than the program's 1979 funding levels. The President has also proposed that funds be used for interest rate subsidies for private firms, and that localities be allowed to use their EDA Title II funds for direct grants to firms.

As background to your consideration of these funding and program initiatives, I will:

- First, review the effects and causes of declining business activity in distressed areas;
- Second, assess the potential impact of an expanded business aid program on the economic and fiscal health of distressed areas; and
- Third, describe several program options that might be considered by the Congress in designing a business development strategy for distressed areas.

Problems of Distressed Areas

The Administration's proposal is aimed at the alleviation of the individual hardships and governmental fiscal problems that result from declining business activity in distressed areas. As fewer new businesses are formed, and as existing firms close, grow smaller, or move out of an area, unemployment levels and dependent populations increase. While the resulting need for government benefits and services grows, local tax bases decline.

Several factors discourage businesses from locating and expanding in distressed areas. Poor local market potential, transportation problems and costs, the limited availability and high cost of land, and the high cost of skilled labor and other resources are the major deterrents to business investment. The limited availability and higher cost of investment funds in distressed areas discourages investment.

Small and new firms find it especially difficult to obtain credit in distressed areas:

- Small businesses, particularly those in small urban areas, are charged significantly higher interest rates than large businesses.

- o Small businesses are denied credit more frequently than are large businesses.
- o New businesses have difficulty securing long-term credit and younger firms face credit limits more often than do established businesses.

These small and new firms provide a large proportion of the employment in many distressed areas, and they are often the ones that wish to expand.

Impact of the Proposed Program

Because the EDA program will fill some of the credit needs of businesses, it will lead to an increase in the proportion of national investment occurring in distressed areas. The program is not, however, likely to cause a massive influx of businesses into these areas because the proposed loans, loan guarantees,interest rate subsidies and grants are largely directed at only one of the deterrents to location in distressed areas--that is, the high cost and limited availability of funds.

Each of the various EDA activities will encourage greater business activity in distressed areas. Direct loans, at an interest rate near to the Treasury borrowing rate, and loan guarantees would be made available to small- and medium-sized firms in order to encourage their

location and expansion in distressed areas. Eligibility for direct loans and guarantees would be restricted to firms unable to obtain private financing. Interest rate subsidies could be used to aid both the riskier firms which can only obtain credit through direct loans and those firms that can obtain private credit with a federal guarantee. Direct grants to firms from local governments would lower some of the cost barriers that deter location and expansion in distressed areas.

Several factors may limit the effect of the proposed program. No explicit provision is made for the needs of new firms that may have difficulty in obtaining start-up funds. Further, without a size limit on the loan guarantees, they may be received primarily by large, established firms that have access to other sources of credit. Under the existing program, 47 percent of the $229 million in outstanding loan guarantees consists of loans to five of the 111 participating firms. For firms with access to private financing, the major deterrents to location in distressed areas are high operating costs, resource constraints such as land availability, and insufficient markets. The EDA program will not directly affect these factors. Thus, if the loan guarantees are given primarily to established firms, they will have little impact on the level of investment in distressed areas.

One of the major limitations on the effectiveness of the EDA proposal will be the extent of credit substitution--that is, the extent to which federal aid subsidizes investments that would have occurred without assistance. If substitution is high, the net effect of the proposal will be reduced. CBO's survey of current recipients of EDA fixed asset loan guarantees found that the assistance was felt to be crucial in about 80 percent of the aided investment spending. Evaluations of business development programs operated by state governments suggest that between 32 to 83 percent of the aid goes to projects that would have been built in the same places without assistance. In general, substitution in a federal program restricted to distressed areas is likely to be lower than in the state programs, few of which are restricted to distressed areas. If the pool of eligible areas is broadened, however, to include more of the nation, substitution will be greater because more of the eligible areas will be those in which some growth is already occurring without aid.

Credit substitution can be lowered if targeting by firm type as well as location is improved. Aid should be focused on small firms with credit problems, rather than on large, established firms for which the availability and cost of funds is a lesser determinant of investment decisions. The availability of interest subsidies might attract firms who do not have capital availability problems and thus may result in increased credit substitution.

Approximately $1 billion in private investment in distressed areas could result from the $569 million requested for Title III of EDA in fiscal year 1980. From $0.2 to $0.7 billion of this would represent projects that would not otherwise have been undertaken in these areas. These estimates assume: that the EDA assistance is divided between direct loans and loan guarantees in the same proportion as occurred in fiscal year 1978; that no interest rate subsidies are granted; and that the rate of credit substitution is similar to that in existing state programs.

This increase in investment will result in increased employment in distressed areas. As businesses form or expand in these areas, new jobs will be created, but it is not clear who will fill these jobs. Many will be filled by workers who are already employed, reducing the impact of the program on the unemployed. CBO's survey of the current EDA guarantee recipients found that nearly half of the jobs created by the program were filled by employed workers. Other studies of similar programs have found even greater percentages of those holding new jobs to have been previously employed. Not all of the jobs vacated by these workers who change jobs will be filled by their former employers, approximately one-fifth to one-half may remain vacant. At the same time, for each 100 net new jobs, an additional 50 jobs will be created indirectly as spending by newly-employed workers increases.

There may also, however, be offsetting employment losses if EDA-assisted credit makes credit harder to obtain for other local job-creating enterprises.

The EDA program will create different kinds and numbers of jobs than those resulting from other federal employment-creating programs such as Public Service Employment (PSE) and Public Works (PW). Most of the jobs directly and indirectly created by the EDA will be permanent, except when loan defaults occur. Only a small share of the jobs created indirectly by such programs as PW are permanent. For every billion dollars in federal spending, the EDA program may yield between 14,000 and 142,000 permanent jobs, in addition to temporary jobs in the construction industry. The estimated federal cost per newly created job ranges from $800 to $4,000 per year of total employment—that is both temporary and permanent jobs created by the EDA program.

Different types of job development programs create jobs for different types of workers. Because of eligibility restrictions PSE jobs must be filled by unemployed or disadvantaged workers. In contrast, construction jobs under EDA and PW tend to be held by skilled, more highly paid workers. The jobs created by the resulting investment may cover the full range of skills. In general, less capital-intensive technology requires lower skill levels; thus firms that are less capital-intensive will be more likely to hire less skilled or unemployed workers.

New business investment stimulated by the EDA program will also ameliorate the fiscal problems of distressed areas, but the extent of this effect is very uncertain. The fiscal effects depend not only on the size of the stimulated investment but also on the type of firm making the investment. New business activity and employment reduce the need for local government spending for dependent populations, but they may also increase the need for additions to public sector capacity. This latter effect may be especially important in older areas. On the other hand, new business activity also increases tax revenues as income, spending, and property values increase. The net contribution of a firm to an area's budgetary position depends on the characteristics of the firm. For example, a chemical products firm will make more demands on sewage treatment facilities than would a business consulting firm. One can say in general that small businesses, existing firms, and labor-intensive firms place the fewest new demands on local public sector capacities but they also contribute less to local property tax bases than do new, large, capital-intensive enterprises. Firms that hire unemployed residents reduce expenditures for dependent populations, but the large and more capital-intensive firms that contribute the most to local tax bases will not be firms that hire low-skilled, unemployed residents.

How Can the Program's Impact on Distressed Areas be Increased?

Improved targeting and better-defined criteria for distributing aid would increase the EDA program's impact on distressed areas.

Targeting. Stronger area eligibility restrictions would lower the rate of credit substitution and increase the share of stimulated investment occurring in the most distressed areas. This would mean including fewer areas and firms and excluding those that are growing independently.

Preliminary reports on the Administration's eligibility criteria suggest that 60 percent of the U.S. population lives in areas that will be eligible for assistance. This contrasts with 78 percent under the expiring legislation and 42 percent under the National Development Bank proposal introduced by the Administration last year. Subject to certain limitations, the eligibility is to be based on an area's meeting any one of five distress or decline criteria: low per capita income; high unemployment (two criteria); employment loss; and high levels of poverty. One way to improve targeting and increase the impact of the program on the most distressed eligible areas would be to require areas to qualify on two or more of the five distress measures.

<u>Distribution of aid</u>. Area and firm eligibility criteria are not the only determinants of where and to whom assistance is provided. Under the proposed EDA program, eligible areas will compete for funding on the basis of specific criteria such as local job impact, project viability, and the degree of area distress. This process will help to assure that aid flows to the neediest areas. The legislation sets no explicit limits, however, on the level of aid that can go to any one project. As a result, a small number of areas could conceivably receive the bulk of the agency's business aid assistance. Under the current EDA business assistance program, guaranteed lending is concentrated among a small number of the participating firms and thus a small number of areas. A restriction on the concentration or the size of aid would ensure that aid would be more evenly divided among those eligible and that it would go to small firms or projects that face greater credit problems.

Expansion of Existing Public-Sector Oriented Programs

Other options available to the Congress that could assist the development of distressed areas include the expansion of programs oriented toward the public sector. Programs such as public service employment, public works, and general revenue sharing attempt to alleviate the individual and fiscal hardships associated with economic decline. While such programs do help in solving some of the problems of these areas, they require continuing federal aid to maintain their

benefits. Public sector programs may encourage private-sector growth, but the response is uncertain and is likely to take a long time. In contrast, a business development program, if successful, can start a self-sustaining process of growth in an area that will require no further aid to maintain it.