

**STUDYING THE PAST AND PREPARING FOR FUTURE  
ECONOMIC DEVELOPMENT**

**OR**

**TRYING TO AVOID FLY-BY-NIGHT OPERATORS AND  
FLY-BY-THE-SEAT-OF-THE-PANTS POLICIES**

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# **Studying the Past and Preparing for Future Economic Development or Trying to Avoid Fly-by-Night Operators and Fly-by-the-Seat-of-the-Pants Policies**

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How do Montanans compete in a global economy? Is there a need to worry about competition for jobs with businesses in Guangdong province in China, Madhya Pradesh in India, or Kildare in Ireland? What is drawing companies to Boise or Provo? In a globally competitive economy, what can or should state government do to help improve a Montana company's competitiveness?

Native Montanan Lester Thurow, a long-time economics professor at the Massachusetts Institute of Technology, wrote in *USA Today* after a 2002 visit to Montana that "Montana residents believe their own slogan--"the last best place" to live. If you believe that, you don't have to sell yourself." After referring to migration into Montana by retired or semiretired people who "enjoy hiring people at the low wage levels that prevail in the area", Thurow said, "They also like the area as it is and don't want economic development. That's why Montana's per-capita income is higher than Mississippi's while its wages are lower."<sup>1</sup>

Thurow is not the only commentator to suggest that Montana has an image of not wanting economic development, whether true or not. Allegations that Montana is not open to business are occasionally heard. In contrast to that image are more than 55 different statutes enacted by legislators and focused on economic development. This report is intended to provide a review of existing economic development programs<sup>2</sup> and an opportunity to analyze what additional programs and policies might be beneficial by looking at the following questions:

- What are the principles underlying economic development policies?
- What programs have been implemented to sustain or improve Montana's economy?
- What other actions can be taken, and what policy principles would be involved?

Not answered in this paper are questions about whether more time is needed to show that measures taken to date eventually will succeed in boosting the state from its last-place ranking among all states in 2000 on average annual pay. Nor will this paper address whether lack of state or local government tax revenue is a problem--as in "it takes money to make money". Nor will the issues of tax and regulatory burdens be addressed. Time and money are always in short

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<sup>1</sup>Lester Thurow, "Poverty Settles in Great Plains", *USA Today*, September 30, 2002, available online at <http://www.lthurow.com/articles/pdf/Poverty.pdf>.

<sup>2</sup>As used in this report, the term "program" includes any action taken by the state or a local government with the stated intent of developing the economy.

supply, while the impact of taxes or regulations tends to be industry specific and difficult to isolate.

To gain a better understanding of what previous Legislatures have created as economic development tools, what programs still exist, what problems occurred previously, and what options may be needed for the future, the Economic Affairs Interim Committee of the 58th Legislature included economic development as a study area in its work plan. This effort is one of many economic development initiatives being undertaken in the state. Among other activities underway is a project called "Shared Leadership for a Stronger Montana Economy", initiated at the prompting of the Board of Regents.<sup>3</sup> The Economic Affairs Interim Committee's exploration of Montana's economic development opportunities is intended to reinforce, not duplicate, other activities. However, once legislation starts to be proposed, the options may flow in many directions.

### **I. What principles underlie current policies?**

A variety of principles characterize existing economic development financing policies, with the overall philosophy being a recognition that economic development improves commerce, business development, job opportunities, standards of living, and prosperity in Montana.<sup>4</sup> Some of the principles include these concepts:

- **The use of tax policy both locally and statewide is appropriate for creating value-adding industries.**
- **State support for specific industries is appropriate.**

#### **A. Tax policies**

Tax policies are two sides of a coin. On one side is the authority to tax. On the other side is the use of favorable tax provisions to encourage business growth. Taxes might be levied or reduced at either the local or the state level.

#### **Local authorities' power to tax**

Among statutes that provide authority to tax are these allowing local governments to authorize:

- a tax for the purpose of economic development (90-5-112, MCA); or
- a tax for economic development and other port authority purposes (7-14-1131, MCA).

The counties listed in Table 1 levy one of the taxes listed above.

#### **Local authorities' power to adjust taxes or tax flows**

In addition to tax increment financing, which allows local authorities to return incremental tax

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<sup>3</sup>For a description of the "Shared Leadership" project, see the project description and a letter to Montana businesses at [http://www.montanachamber.net/ws/aboutus3.php?page\\_id=4876](http://www.montanachamber.net/ws/aboutus3.php?page_id=4876).

<sup>4</sup>This specific list is in 7-14-1104, MCA, which sets forth port authority purposes. Many other statutes have a similar list.

revenue to a specified tax increment financing district (as provided in 7-15-4282 through 7-15-4293 and 7-15-4296 through 7-15-4299, MCA), various other options allow exemption or partial exemption from local property taxes for:

- new or expanding industry, pursuant to 15-24-1402, MCA (50% of taxable value for the first 5 years after a construction permit is issued for qualifying changes);
- business incubators owned or leased and operated by local economic development organizations (15-24-1802, MCA);
- industrial parks owned and operated by local economic development organizations (15-24-1902, MCA); or
- buildings and land owned by a local economic development organization and intended for sale or lease to a "profit-oriented, employment-stimulating business" (15-24-2002, MCA).

**Table 1: Economic Development or Port Authority Levies in Montana Counties in 2002-03**

County	Economic Development Levy 2002-03	Port Authority Levy 2002-03
Custer	1 mill (not in cities/towns)	
Dawson	1 mill	
Flathead		2 mills
Richland	0.43 mill	
Silver Bow	1.14 mills	2.7 mills
Toole		2 mills (not in cities/towns)
Yellowstone		2.48 (not in cities/towns) Big Sky EDA

Source: Data from Montana Tax Foundation, *Montana Property Tax Mill Levies 2002-2003*.

### **State use of taxes or tax policy**

State tax-related actions are illustrated by statutes authorizing:

- tax credits for venture capital investments (90-8-202, MCA) under the Montana Capital Company Act. Tax credits are no longer available.
- use of interest income from \$140 million of the coal severance tax permanent fund deposited in the general fund for economic development purposes (15-35-108(7), MCA);
- use of a portion of the coal severance tax bond fund for a treasure state endowment fund and treasure state endowment regional water system fund to help local governments provide infrastructure (key for economic development) (17-5-703(4)(a) and 4(b), MCA);
- use of bonds (or notes) for infrastructure projects or for projects valued at more than \$800,000 that meet the purposes of 17-5-1502, MCA, under the Montana Economic Development Bond Act of 1983;
- tax credits to businesses that are charged a fee for using infrastructure improvements

- financed through Board of Investment grants to local governments (17-6-316, MCA);<sup>5</sup>
- the potential, under certain conditions, of the class eight property tax (business equipment and property listed in 15-6-138, MCA) being reduced from the current 3% rate to zero;<sup>6</sup>
- tax credits of up to 50% for certified expenditures related to mining exploration;<sup>7</sup>
- credits provided to businesses that receive a grant for new job training, as provided in House Bill No. 564 of the 58th Legislature (Title 39, chapter 11, parts 1 and 2, MCA);<sup>8</sup>
- credit equal to 5% of the increase in qualified research expenses and basic research payments for research done in Montana--based on Internal Revenue Code qualifications (15-31-150, MCA);<sup>9</sup>
- exemption from corporate license tax on net income earned from research and development activities of registered firms for the first 5 years of taxable activity (15-31-103, MCA);<sup>10</sup>
- tax credits to offset corporate income taxes and insurance premium taxes, based on increased employment in empowerment zones and other criteria (7-21-3710, MCA);<sup>11</sup>
- exemption from state individual and corporate income tax (Title 15, chapter 33, part 1, MCA) of capital gains or dividend income from investments in a small business investment company, defined under the federal SBIC statutes. Montana has no SBIC. However, Glacier Venture Fund has applied for a SBIC license.
- tax credit for the cost of property used to collect, process, or produce a product from reclaimed material or from depreciable equipment that treats soil contaminated by hazardous waste (15-32-602 and 15-32-603, MCA); and
- tax credit against eligible expenditures for depreciable equipment used in certain renewable energy generation units (15-32-402, MCA).<sup>12</sup>

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<sup>5</sup>A related job credit is available under 17-6-318, MCA. Companies that have used one or both tax credits include: ASiMI, Montana Resources, and Wells Fargo Bank Service Center.

<sup>6</sup>The trigger for change has not yet been met, based on the requirements of 15-6-138(5), MCA.

<sup>7</sup>No individual or corporate income taxpayer had qualified through 2002 or 2003, respectively, for this tax credit, according to the Department of Revenue.

<sup>8</sup>Eight companies have applied for this tax credit/grant as of April 2004.

<sup>9</sup>Department of Revenue statistics show qualification for corporate tax credits numbered: 3 organizations in 2000, 5 in 2001, 8 in 2002, and 10 in 2003. Qualifying individual income tax credits numbered four in 1999 and three in 2000, the last date listed.

<sup>10</sup>Department of Revenue statistics list two organizations qualifying for this tax credit in 2000 and 2001 and one qualifying in 2002 and 2003.

<sup>11</sup>Eligibility begins with tax periods after October 1, 2003.

<sup>12</sup>For more details about the tax credits, see the Montana Department of Revenue website: <http://discoveringmontana.com/revenue/css/3forbusinesses/03taxincentives/corporation.asp>.

## **B. Emphasis on certain industries**

Although some economists warn against picking and choosing industries for special consideration out of a concern that a wrong choice would mean misspent funds, Montana legislators have chosen to emphasize the importance of agriculture and tourism--considered the state's top two economic engines--through decisions to allot certain tax money to these industries. Coal severance tax funds are provided for agriculture in the Growth Through Agriculture program (15-35-108(7)(b)(ii), MCA, and Title 90, chapter 9, parts 1 through 3) and in the Research and Commercialization program (15-35-108(7)(c), MCA, and Title 90, chapter 3, part 10). The tourism industry receives funds from the lodging facility use tax (15-65-121, MCA).

There are more principles than those listed above that underlie policies for economic development. In part, the choice of these principles and policies relates to a definition of economic development as being the creation of an environment supportive of the needs of business and of policies that promote more job opportunities, retain existing jobs, boost income levels and standards of living, and expand entrepreneurship.

## **II. What economic development programs have been implemented to sustain or improve Montana's economy?**

A wide range of programs exists statutorily in Montana for promoting economic development. On one side of the spectrum, state agencies offer guidance and business advocacy. At the other end, the state provides partial financing and economic support. **Appendix A** provides a review of both state and federally supported economic development programs in Montana. This paper is not intended to evaluate the success of the state's current programs for sustaining and improving Montana's economy but instead is intended to direct attention to the roles that the state plays in economic development. By reviewing what the state currently does, legislators may determine whether to maintain or seek to change existing priorities.

- As an advocate, government expends staff time and program dollars in promoting various forms of economic development. These advocacy efforts are achieved through phone calls and intergovernmental cooperation and collaboration to help businesses make appropriate contacts with other businesses or lenders.
- As a partial financier, the government makes funding available through myriad grants and loans to help businesses in the startup or low-growth stage.
- As an incentive-provider, the government earmarks some public funds for certain activities, puts forward some research money, and provides some tax offsets or tax credits to spur innovation or new businesses.

### **A. Advocacy and guidance roles**

The state Departments of Commerce and Agriculture each have major functions to promote business and industry in the state. Similarly, the Governor's Office of Economic Development

provides both a bully pulpit and a networking function in bringing attention to projects considered beneficial to the entire state. The 57th Legislature created a Financial Assistance Center in the Department of Commerce (90-1-144, MCA) to make certain that information was available in one place for various state financial assistance programs, not just those at Commerce. No additional funding was provided for implementation. (See <http://www.mtfinanceonline.com/>.) The Shared Leadership program being promoted across the Legislative and Executive Branches of government through the Board of Regents also is promoting the sharing of information.

Funding for these roles is through the state general and special revenue funds and sometimes through federal dollars, such as the Community Development Block Grant program under the U.S. Department of Housing and Urban Development (HUD). The Department of Commerce has fended off diversion of the lodging facility use tax, which supports tourism promotions. During the 2003 legislative session, Commerce successfully argued that funding of certain economic development-related programs, such as those listed in 15-35-108(7), MCA, should be stable through June 30, 2010. These programs will be discussed below, because they fit under the partial financier role of state government.

## **B. Partial financier role**

The state provides a variety of direct appropriations for economic development, channels money from the federal government for economic development, and makes decisions through the Board of Investments on whether to provide loans to businesses that meet the criteria of 17-6-309(2), MCA:

The board may make a loan to enhance economic development and create jobs in the basic sector of the economy, as defined by the board by rule, if the loan will result in the creation of a business estimated to employ at least 15 people in Montana on a permanent, full-time basis or result in the expansion of a business estimated to employ at least an additional 15 people in Montana on a permanent, full-time basis or raise salaries, wages, and business incomes of existing employees and employers.

The Board of Investments also can make commercial loans to eligible businesses under 17-6-305, MCA, and value-added loans under 17-6-317, MCA. Under legislation enacted in 2003, the Board of Investments can put \$5 million from the in-state investment program described in 17-6-305, MCA, into an intermediary relending program for loans to economic development organizations, as described in 17-6-345, MCA. These organizations are to use the loans for matching funds required by certain federal programs.

### **A sample development loan package**

A \$33.7 million package of loans is the largest to date for the Board of Investments under 17-6-305 and 17-6-317, MCA. The Board authorized the loans, contingent on compliance with Board policies and state law, for International Malting Co.'s construction of a \$60 million barley malting plant near Great Falls.

In various other programs, the state also serves as partial financier. For example, each year the state takes interest from \$140 million of the coal severance tax permanent fund and assigns it to a statutorily appropriated account in the general fund, specified in 15-35-108, MCA. This money is allocated to:

- the Montana Cooperative Development Center (operated out of the Department of Agriculture);
- the Growth Through Agriculture program (also a Department of Agriculture function);
- the Research and Commercialization program (operated out of the Department of Commerce);
- the Department of Commerce for:
  - a Small Business Development Center;
  - a small business innovative research program;
  - certified regional development corporations;
  - the Manufacturing Extension Center; and
  - export trade enhancement.

In helping small businesses, the Department of Commerce oversees a Microbusiness Loan Development program, created in 1991 under Title 17, chapter 6, part 4, MCA, to "foster and

<b>1998-2003 Microbusiness Award Winners</b>	
1998	Total Body Raquetball & Fitness Center, Lewistown
1999	La Casa (senior assisted living facility, Plentywood
2000	Doc's Gourmet Sandwich Express, Missoula
2001	Le Petite Outre (Great Northern Bakehouse), Missoula
2002	Eichel Enterprise, Inc. (auto repair), Billings
2003	D&J, Inc. (grocery, hardware, and gas station), Harrison

encourage economic development within the state in order to promote the general welfare of the people . . .". The program is limited to assisting businesses with fewer than 10 full-time employees and less than \$500,000 in gross annual revenue. The statement of purpose in 17-6-402, MCA, also says that the program is for businesses with financial needs not met by either the public sector or the private sector. The Legislature appropriated \$3.25 million in 1991 and another \$3.25 million in 1995. The money was loaned to Microbusiness Development Corporations (MBDCs), often affiliated with local economic development organizations.

These MBDCs then signed 4-year, renewable

contracts, agreeing to meet the state terms that limit loans to \$35,000 for each applicant and require a match of \$6 in local money for each \$1 in program money. The loans are to be repaid to the state at a 2.75% interest rate.

Some of the original organizations--in Bozeman, Glendive, and Lewistown--have paid back the original loans with interest. The Southeastern Montana Development Corp. in Colstrip is in the process of doing so. See **Appendix B** for more details about the program.

The Department of Commerce also handles the Community Development Block Grant program for HUD; the Small Business Development Center program for the U.S. Small Business



Administration; and the Small Business Innovative Research program, which provides assistance to Montana businesses competitively vying for federal research grants. In some cases, state general fund money helps to support these programs. In other cases, federal money backstops the programs.

#### **Incentive Case Study in Billings**

Bresnan Communications announced in April 2004 its choice of a Billings site for a regional operations center. The center is expected to create 100 new jobs and pay \$65.6 million in wages over the next 10 years. Over that time, the direct input to city and county tax coffers is estimated to reach \$2 million.

The \$1.6 million incentive package organized by the Big Sky Economic Development Council included:

- federal funds for construction;
- county funds from Big Sky EDA;
- private funds from the Big Sky Economic Development Corp.; and
- state training grant funds under Title 39, chapter 11, part 2, MCA.

*Billings Gazette*: "Savvy clinches cable deal", 4-21-04

#### **C. Incentive provider role**

One goal of growing the economy--an economic development model that goes beyond sustaining current jobs--is to bring more outside dollars into Montana instead of recirculating existing dollars. New businesses, particularly new businesses that have sales or service contracts with out-of-state customers, do just that. Research and development or construction grant money from the federal government does that also. The state's role in creating incentives for luring new businesses as well as federal grant dollars to Montana sometimes involves promises, like tax credits or matching funds for grants.

In the case of tax credits, the state decides that forgone revenue is worth the risk that a new business eventually will generate downstream revenue, either in the form of income taxes, business taxes, or property

taxes. In the case of research grants, the state puts money up front to show its confidence that a project is worthy of support.

The state has had questionable experiences with risk assumptions for some tax credits and research loans intended to provide seed capital to new businesses. Under the Montana Capital Company Act (Title 90, chapter 8, MCA), enacted in 1983, the state provided tax credits to certified companies that had a minimum of \$500,000 in capital (or \$200,000 for some organizations). Analysts of the tax credit program said that the statute required no proof that an investment provided jobs and, until amendments were adopted in 1991, allowed those investing in the certified companies to use the investments in their own companies and still get tax credits.<sup>13</sup> The statutes also did not require full investment because the state decertified companies once they could show that they had put 70% of their funds into investments. That means that the certified companies, if they chose to do so, could return to the original investors the remaining

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<sup>13</sup>See Montana Capital Companies Annual Report to the Revenue and Transportation Interim Committee, February 13, 2004, Exhibit 10.

30% put up as investment funds. Because the investors also received tax credits, which could amount to 50% of the original investment, and also until 1991 could put the money into their own projects, the Montana Capital Company Act left a bad memory for some. They saw certain investors gaining tax credits for investments that they already were making and the state losing revenue of \$7.61 million.<sup>14</sup> Various others have said that the Montana Capital Company Act did increase investment in Montana and created some successful, arm's-length investments in companies that continue in business.

Another bad memory is associated with the Science and Technology Development Board, which was authorized to provide seed capital for Montana businesses, particularly those involving innovative technology with a potential for commercial success. The goal was to develop loans, but the agreement allowed convertible debentures and warrants. (Debentures and warrants represent debt that can be converted to equity.) Although the constitutional ban on the state holding most types of equity investments meant that the Science and Technology Development Board could not convert the debenture or exercise the warrant, the Board could sell these debentures and warrants to others. In some observers' eyes, the problem with the science and technology alliance statutes (Title 90, chapter 3, MCA) was that the ban on the Board's holding of equity made it difficult to effectively use the debentures or warrants to obtain repayment of its investment. In others' eyes, the complaint about the program was that loan repayments were slow in coming in (debt service could be delayed up to 8 years). When the science and technology alliance statutes were repealed in 1997, the Legislature assigned to the Board of Investments the duty of handling the program's loans. The Board has written off slightly more than \$1,588,000 in principal and interest on five loans that originally were for \$3,910,500. Payments continue to come in for approximately 15 loans. See **Appendix C** for details.

### **III. What other actions can be taken, and what policy principles are involved?**

With a history of making loans to businesses in small communities and occasional loans to larger businesses that meet criteria set forth by statute and the Board of Investments, the questions are: Should Montana look at what other states are considering in an effort to identify what more to do for economic development than it is doing now? Should Montana revise the programs that currently get state support? Should Montana follow new policy choices to further stimulate the economy?

#### **A. What other states are doing**

If Montana wants to compete more actively with other states for business, then the choices and costs are wide-ranging. Table 2 lists options for economic development being considered by state legislatures meeting in 2004. The risk of such competition is that this creates "economic war among the states", which is how a Minneapolis Federal Reserve Bank report from 1994 characterized some intrastate competition for businesses. In some eyes, a competition among states is a race to the bottom because a state may have to offer so many incentives that the cost becomes equal to or more than the benefits that the developments bring in. The incentives also

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<sup>14</sup>Fiscal Note for Senate Bill No. 378, proposed in the 58th Legislature.

may result in a shifted tax burden from one group (the newcomers) to another group (existing taxpayers) if location incentives involve forgone taxes combined with subsidy packages or other incentives.<sup>15</sup> Nevertheless, if one state offers tax credits for research and development or provides corporate income tax exemptions, do all states need to react similarly to provide a level playing field? Or are certain competitions not worth engaging in--particularly if transportation and location disadvantages outweigh other options?

**Table 2: Actions considered by other states in 2004 to increase economic development\***

<b>Tax Measures</b>	<ul style="list-style-type: none"> <li>• Tax reform or cuts - South Carolina, Hawaii, Maine, Oklahoma, Virginia, Vermont, Kentucky, Iowa, Michigan, Minnesota, New Mexico, Ohio, Pennsylvania, Utah</li> </ul>
<b>Business Climate</b>	<ul style="list-style-type: none"> <li>• Infrastructure development: Colorado, Georgia, Kansas, Maryland, Minnesota, New Mexico, Pennsylvania, Rhode Island, Tennessee, Virginia, Washington</li> <li>• Reform of unemployment insurance - California and Massachusetts</li> <li>• Reform of workers' compensation - California, Ohio, New York, Vermont</li> <li>• Tort reform - Ohio, Mississippi, Oklahoma</li> <li>• Regulatory/licensing reform - Michigan</li> <li>• Lower business fees - Hawaii</li> </ul>
<b>Targeting Tourism</b>	Iowa, Colorado, Maine, Minnesota, Mississippi, Pennsylvania, South Dakota, West Virginia, Wyoming
<b>Targeting Other Industries/Employers</b>	<ul style="list-style-type: none"> <li>• New Jersey - legalized stem cell research (to spur biotech, pharmaceutical research)</li> <li>• New Mexico - film industry incentives</li> <li>• Alabama - space industry incentives</li> <li>• Alaska - natural gas pipeline proposed</li> <li>• Utah - outdoor recreation emphasized</li> <li>• California, Maine, New Mexico, Utah - developing international trade</li> <li>• Alabama, Arizona, California, Georgia, Kansas, Ohio, Oklahoma, Mississippi, New Mexico, Utah - considering how to retain military bases</li> </ul>
<b>Workforce Training</b>	<ul style="list-style-type: none"> <li>• Ohio Workforce Guarantee - state to recruit, screen, train workers if firm creates 100 jobs</li> <li>• Maine - conference to develop strategies for innovative workers</li> <li>• North Dakota - "Opportunities 2020" places college students in internships designed to keep graduates in state</li> </ul>

\*Based on article by Laurie Clewett, "State of the States", in *State Government News*, March 2004, pp. 20-22, 34.

How does a state determine whether actions being taken in another state are worth imitating or using as a model? One option is to consider whether the principles required for a policy are in line with the current thinking among legislators and officeholders.

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<sup>15</sup>Greg LeRoy, "Trends in State Business Incentives: More Money and More Accountability", *Spectrum: The Journal of State Government*, Vol. 77, Number 1, Winter 2004, pp. 15-18.

Another approach is to review the state's strengths and determine what policies might suit those strengths. The "Montana Industry Cluster Analysis", a May 2003 study prepared by Regional Technology Strategies, Inc., for the Governor's Office, suggests that focusing on clusters of business activity in Montana rather than on individual firms would provide the most "strategic, systematic, and efficient" use of public money for economic development.<sup>16</sup> The study also emphasized that certain policies--such as workforce development and education--are critical to all clusters. Montana's social and recreational attributes also are important for attracting innovators and talented people who have a choice of where they live and work. The study notes that ""amenity values" have emerged as the chief new source of rural comparative advantage".<sup>17</sup> As legislators consider new economic development policy proposals, they may want to see how well different policies support the following clusters of business activity identified in the study: wood-based products; agrifood; tourism and recreational or other experience-based activities; creativity (art, web page designers, landscape architects); life sciences (biotechnology affecting humans, agriculture, or environmental applications), and information or optical/analytical technologies.

**B. Principles--pros and cons--that could shape future economic development policies**

Pro and con implications accompany each of the following principles as a way of stimulating the debate about what future actions Montana might take to encourage economic development.

<b>Financial support for an economic development project must be transparent; a direct appropriation from the general fund is one transparent approach.</b>	
<p><b><i>Implications -- Pro</i></b></p> <ul style="list-style-type: none"> <li>• Transparent assignment of general fund money acknowledges state support, is straightforward, can provide accountability, and must compete with other worthy programs for funding.</li> <li>• The general fund is an appropriate source of funds because economic development theoretically feeds into the general fund through income tax and other tax generation from new jobs and profits.</li> <li>• The general fund provides flexibility on a biennial basis and avoids the prospect that earmarked funds continue to contribute to programs that are no longer viable.</li> </ul>	<p><b><i>Implications -- Con</i></b></p> <ul style="list-style-type: none"> <li>• Economic development programs need a stable source of funding, one that does not fluctuate with the economy.</li> <li>• Other forms of financial support, such as tax credits, may be the appropriate policy because they can be tailored to create incentives for specific purposes, even though they are not readily transparent.</li> </ul>

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<sup>16</sup>Regional Technology Strategies, Inc., "Montana Industry Cluster Analysis: Executive Summary and Recommendations", May 2003, p. 1.

<sup>17</sup>*Ibid.*

**The state must not be a financier of last resort and must not be a lone investor in any private project.**

***Implications -- Pro***

- Stated positively, the state must be one of several financiers so that the state does not assume risks that other prudent investors avoided. Being one of many investors is a way of adhering to the prudent expert principle stated in Article VIII, section 13, of the Montana Constitution.
- By being one of several investors, the state can rely on other investors to do due diligence on a project's worthiness.

***Implications -- Con***

- The state has often taken the role of provider of last resort--for example, making certain that workers' compensation insurance is available to those that private insurers may choose not to cover. Workers' compensation is required by state law. No similar requirement exists for investment in certain industries. The state may consider certain investments to be so critical to an industry that the state chooses to take a limited financing opportunity.
- Some projects important to the state may relocate to another state or country if Montana does not take the initiative to provide support, whether private investors are willing to assist or not.

**The private sector and not the state is best suited to take a direct role in management of economic development investments, other than those investments coordinated through the Board of Investments (which is required to operate under the prudent investor rule).**

***Implications -- Pro***

- The private sector can use its profits to hire sufficient expertise to compete in a for-profit investment world.
- The state's business is not business per se. Investments should be outsourced to professionals who are in the business of investing.

***Implications -- Con***

- The state has made exceptions to its salary schedule to allow the hiring of experts who can compete knowledgeably with those in the for-profit world. The state could do the same for economic development initiatives.
- Keeping a state employee in charge of investments would avoid fee payments for managing state funds.
- Oversight can be required to make certain that state investments are made wisely and not treated as "free money" by employees who are not contractually obligated to invest wisely.

**An economic development financing program developed by the state must result in some return to the state, showing accountability either through property tax payments made by the firm that benefited from economic development financing, jobs provided and corresponding income tax returns, or loans repaid with interest.**

***Implications -- Pro***

- The state's purpose in providing economic development financing is to generate jobs, increase income, or establish better living standards in the state. If a firm that receives benefits from state-supported economic development programs cannot provide some accountability for success (whether through property tax payments locally, income tax payments from more jobs, or higher salaries) or sufficient revenue generation to pay back state loans with interest, then the economic development financing program may not be worthwhile.

***Implications -- Con***

- Businesses come and go, not always because of their own merits but sometimes because they fall victim to economic downturns or other unanticipated problems. Requiring payback or some form of proof that the state's financing helped the business to succeed does not necessarily prove that the success was due to the state's money or that the specific failure means that the program was an overall failure.
- Each accountability measure requires more regulation or paperwork that a struggling or young company is ill-equipped to handle.

**The state apportions economic development risk to the entire state when appropriate but to specific groups or locations otherwise.**

***Implications -- Pro***

- In financing, the state may weigh the use of funds available in the public retirement systems or state compensation insurance fund (for which equity investments are allowed) by deciding who benefits and whether the risk is appropriate to the benefits. Risky projects, if they pay off, may benefit the entire state economy. If they do not pay off, the costs to make the system whole could be apportioned to the entire state instead of fund contributors.
- In determining which entity should provide funding for a project, the determination should be based on whether jobs (when income taxes go to the state) or property taxes (paid locally) are the main result. If income taxes are the main result, the project financing should fall to the state. If property taxes are the main result, the local authority should provide financing.

***Implications -- Con***

- The only funds available to the state for investment in equity financing are the public retirement system and state compensation insurance funds. They provide a pot of money from which the state can make equity investments, and if the investments fail, the entire state may not be made responsible for making the funds whole. In that case, only fund contributors would be the backstop for these funds.
- Local financing authorities have limited funds and should not bear the sole risk for an economic development project that may benefit the entire state.

#### IV. What new or revised actions are possible and at what cost?

Four meetings of an Ad Hoc Working Group on Economic Development and Venture Capital resulted in disparate ideas, not mutually exclusive, of how the state can best improve its policies regarding economic development.<sup>18</sup> From these ideas, the following policy options evolved, ranging from taking no new actions to creating new programs aimed in particular at filling the financing gap for fast-growing companies that need equity rather than debt financing. The options listed below reflect different aspects of economic development: maintaining existing businesses and the status quo and expanding or adding programs in ways that help the economy to grow.

##### A. Community survival/revival--maintaining economic development and the status quo

Among the existing programs intended to serve communities are loan and grant-based programs. These include programs funded through the coal tax trust fund (or interest on the fund): Certified Regional Development Corps., the Growth Through Agriculture program, the Research and Commercialization program, the Microbusiness Development Loan program, and the Treasure State Endowment program.

<b>Option 1: Continue existing programs.</b>	
<b>Issues:</b>	<ul style="list-style-type: none"><li>• Certified Regional Development Corps. were created by the 58th Legislature to provide grants to up to 12 regional development organizations statewide. CRDCs have funding through 6/30/2010, unless renewed or ended prior to that time.</li><li>• The Growth Through Agriculture program also expires 6/30/2010, unless renewed or ended prior to that time.</li><li>• Microbusiness development loans are considered by many development officers to be loans of last resort. As a result, they may not be used as much as other loans, which means the money may be relatively unproductive. The return to the state is 2.5% on the loan.</li></ul>
<b>Costs:</b>	<ul style="list-style-type: none"><li>• Lost opportunity cost for other programs.</li><li>• Continued costs for current personnel and operations, but no additional costs.</li></ul>

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<sup>18</sup>The ad hoc working group consisted of the following individuals who participated in meetings either in person or by phone: Evan Barrett, Gary Bloomer, Rosalie Cates, Keith Colbo, Russ Fletcher, Dave Gibson, Liz Harris, Deborah Hayden, Jacqueline Lenmark, Bill Lombardi, Jon Marchi, Tom McMakin, Gary Morehouse, Margaret Morgan, John O'Donnell, Karen Powell, Anita Varone, and Thomas Wells. Those who were on the e-mail list for meeting notices and information included: Brad Bauman, Lonnie Bookbinder, Mike Carlson, Monte Giese, John Kramer, Roger Lang, Andy Poole, David Senn, Mark Simonich, Ray Trumpower, Greg Van Horssen, and Mary Whittinghill. Meetings were held in Helena January 6, 2004, February 6, 2004, February 20, 2004, and March 26, 2004.

**Option 2: Modify programs, such as the Microbusiness Development Loan program or the Research and Commercialization program, to improve use of funds.**

<b>Issues:</b>	<ul style="list-style-type: none"> <li>• <b>Microbusiness Development Corps. (MBDCs)</b> -- The state may seek to renegotiate contracts with MBDCs to get some of the money not used as reserves and not loaned out so that it goes back into state circulation for economic development. The state then could redistribute money to areas that are fast growing or that need additional assistance.</li> <li>• <b>Research and Commercialization</b> -- Although the statute creating this program allows either grants or loans, the program has committed only grants so far. These mainly go to universities. They provide a definite boon to the economy, particularly to the local economies both directly and through the additional matching or "follow-on" funds that they generate. However, if this program made more loans, especially to nonprofit organizations that currently receive grants or to university projects in which professors create companies that then commercialize a product from the university-based research project, the state could put some of the loan proceeds into a revolving economic development account.</li> </ul>
<b>Costs:</b>	<ul style="list-style-type: none"> <li>• Costs of contracting to handle loans.</li> <li>• The loss of grants may result in the loss of research and the "follow-on" money that comes from outside grants because nonprofit organizations that receive money from the Research and Commercialization program do not necessarily generate the revenue needed to pay back loans.</li> </ul>

**Option 3: Expand the advocacy role of state government to encourage investor networking assistance.**

<b>Issues:</b>	<ul style="list-style-type: none"> <li>• Through funding, the Legislature may choose a state office or an outside agency to encourage investor networking assistance or entrepreneurial training opportunities.</li> <li>• The Legislature could provide directives to the Governor's Office of Economic Development, the Department of Commerce, or another entity on how existing funding should be spent, including the support of networking among angel investors, who are individuals who meet income or wealth qualifications set by the Securities and Exchange Commission.</li> </ul>
<b>Costs:</b>	<ul style="list-style-type: none"> <li>• The Legislature may decide to directly fund activities, which entails a specific appropriation.</li> <li>• The Legislature may choose to make a low-cost recommendation that certain activities be undertaken within the existing budget, recognizing that the suggestion does not have to be carried out.</li> </ul>

**B. Expanding economic opportunities in a way that generates economic growth**

An improved economy requires not just one or two jobs for each business startup, but the growth of existing businesses or the startup of new businesses that add 10 or more jobs, particularly jobs that pay well and boost the state's economy. Selling products or services outside the state or bringing outside money into the state is a critical bonus of economic



development programs intended to boost the state's economy. The state's role may be to provide direct grants, loans, or program assistance. Most programs promoting economic development in Montana provide grants or loans. No state programs directly address the stage of business growth in which equity financing is involved. (A growing company can assume only so much debt before expansion expectations lead to taking on additional equity investors or partners.)

The following options address different capital formation incentives, including some that incorporate state involvement with equity financing of growing companies in Montana. Not included are options that directly involve expansion of education or workforce training.

The question of where financing comes from to pay for some of these programs relates back to the principles listed earlier in this paper. Programs to boost the state's economy often "take money to make money", but deciding how to fund the programs involves policy choices.

Among concerns voiced by the ad hoc working group were the importance of:

- private-sector delivery in equity programs. (The private sector can help to remove decisionmaking from political influence and can hire appropriate expertise.)
- the broadest pool of investment opportunities possible. (Some programs limit investment opportunities to the state or a particular geographic area of the state. Each limitation results in a potential restriction regarding maximum return on an investment. The number of deals in Montana is not considered adequate either to provide a maximum return on all investments or to use all investment dollars wisely.)

**Option 4: Develop new incentives, such as tax credits for angel or early-stage investors who take equity stakes in, and provide management guidance to, existing companies.**

**Issues:**

- Tax credits are a tradeoff in which the state agrees to forgo state revenue in the expectation that more jobs, better pay for existing jobs, or both will result from the investment for which tax credits are provided. If not carefully structured, the tax credits may result in only half of the equation--lost revenue.
- Tax credits can be structured to reward those who take risks, recognizing that risks also may end in failures. Without tax credits for investments in Montana firms, risk takers may take their money to other states that reward risk through tax credits.
- Various investment models employ tax credits.
  - (a) Tax credits can be deferred and tied to a return on the investment contract, which is an approach generally used by the Fund of Funds in Oklahoma and just approved in Utah. SB 465 in the 2003 Montana Legislature used this approach.
  - (b) Tax credits can be made available to a capital company (CAPCO) venture fund, which provides the tax credits to its investors. This model is used in Louisiana, among other states. SB 378 in the 2003 Montana Legislature relied on this model.
  - (c) Tax credits for "angel" or individual investors can be structured to recognize an investment above a specified dollar amount in a "mezzanine" or venture fund or in companies meeting criteria set by the state.

<p><b>Option 4</b> <b>Costs:</b></p>	<ul style="list-style-type: none"> <li>• Lost revenue and opportunity costs for the general fund.</li> <li>• Potential for indefinite tax credit payouts if a limit is not put on amounts. (The Montana Capital Company Act under 90-8-202, MCA, authorized tax credits up to a specified amount each year. All tax credits under this Act have been authorized.)</li> <li>• Costs for CAPCOs may be illustrated by Colorado's experiences: <ul style="list-style-type: none"> <li>(1) tax credits provided to CAPCOs by the state were immediate, while an equivalent amount of investments were made over a longer period;</li> <li>(2) substantial fees were paid for management, meaning that tax credits paid for xx amount of investment correlated to xx amount of investment minus yy amount in management fees;</li> <li>(3) the CAPCO investments were required to be in rural areas, but some of the investments were borderline (in a rural-urban interface); and</li> <li>(4) CAPCO expenses, including lobbying, could be spent from the investments.<sup>19</sup></li> </ul> </li> <li>• Fund of Funds proposals have a management structure that entails upfront costs. A Fund of Funds model that defers the use of tax credits avoids tax credits as an upfront cost and results in credits being used only if returns to investors do not reach an agreed-upon level. If investments fall short of the agreed level, the economy is most likely suffering, which is a cost to the state when other revenue may be falling short. Supporters point out that no state with a Fund of Funds has had to exercise the tax credit option.</li> <li>• The costs for tax credits to angel investors may be political in that such credit would benefit rich individuals, those with annual incomes over \$200,000 and net worth topping \$1 million, according to the Securities and Exchange Commission.</li> </ul>
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<p><b>Option 5: Provide tax credits to investors on capital gains from Montana business deals.</b></p>	
<p><b>Issues:</b></p>	<ul style="list-style-type: none"> <li>• A capital gain results from a successful sale of an equity interest in a company. If the company is not a success, a capital gains tax credit would not be available. A tax credit reduces state revenue but may yield success in other ways.</li> <li>• An investor benefits only on successful investments. Not all investments in growth firms are successful. Based on interviews by Tech Ranch, a program out of Bozeman that encourages seed investments in Montana companies, most investors prefer upfront tax credits to tax credits against capital gains.</li> </ul>
<p><b>Option 5</b> <b>Costs:</b></p>	<ul style="list-style-type: none"> <li>• The state's cost is in direct correlation to the success of a venture, which means that the tax credit could be offset by increased income tax payments from the successful venture.</li> <li>• The investor would bear the risk and benefit only from successful ventures.</li> </ul>

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<sup>19</sup>In October 2003, the Colorado State Auditor reviewed the return on the state's \$100 million provided in 2002 tax credits to CAPCOs for the \$100 million that the CAPCOs received from investors. Of the CAPCO investors' amount, \$11.3 million went to the CAPCOs' startup and related costs and \$44.3 million was set aside to guarantee cash repayments to investors. Of the remaining \$44.4 million available for direct investment, \$3.9 million went to management and other expenses, including lobbying, \$9.2 million was actually invested as of July 31, 2003, and the remainder was still available for investment. Report of the Colorado State Auditor, "A Review of Colorado's Certified Capital Company Program", October 2003, pp. 9-11.

**Option 6: Require the Board of Investments to invest either some of the 25% of the permanent coal tax trust fund referenced in 17-6-305, MCA, or a specified portion of public pension funds through private investment firms that have an office in Montana and can demonstrate that they provide seed or equity capital to Montana companies or review financing requests from Montana companies in each investment cycle.**

<p><b>Issues:</b></p>	<ul style="list-style-type: none"> <li>Using a portion of the coal tax trust fund to make equity investments directly in Montana businesses would require a constitutional amendment to Article VIII, section 13, which states that "no public funds shall be invested in private corporate capital stock" except for public retirement system assets and a portion of state compensation insurance fund assets. (Voters defeated a 2001 referendum that would have amended the Constitution to allow the Board of Investments to invest public funds in private corporate capital stock. A specified portion of pension funds currently can be invested directly in Montana companies without a constitutional amendment.)</li> <li>Care would need to be exercised if a directive "required" investment--or a demonstrated consideration to invest--rather than "encouraged" investment, the current thrust of 17-6-305, MCA. By requiring a certain portion of funds to be invested in-state, the investment could result in a violation of the prudent investor rule, a constitutional requirement, because not all Montana investments would provide a higher return than investments outside the state.</li> <li>Currently, the Board of Investments loans only in concert with banks. Banks conduct due diligence and tend to invest primarily, if not wholly, in deals that have collateral. These types of deals may not accommodate fast-growing companies, such as information technology companies, which have high risk but also the potential for high rates of return. By directing an investment, which is not necessarily a loan, to be handled by a third-party, this outside contractor could handle due diligence.</li> </ul>
<p><b>Costs:</b></p>	<ul style="list-style-type: none"> <li>For each percentage of the coal tax trust fund invested in Montana when the investment returns are uncompetitive with investments elsewhere, the state would lose money. The loss of money would have to be weighed against the increase in the number of jobs created or the higher income from existing jobs from the investment to determine if, on balance, the investment cost or earned the state money over time.</li> <li>One choice in developing directives on investment is that Montana money be spent on equity stakes in Montana businesses. However, that type of directive may not be prudent because the quality and the number of deals in Montana are not necessarily as good as elsewhere. Allowing Montana money to be spent elsewhere is difficult politically but is prudent (and is already being done). The change in emphasis under this option would be to require consideration of Montana business deals and financing of them when appropriate in the equity--not debt--realm.</li> <li>A firm willing to have an office in Montana may not provide the highest returns.</li> </ul>

**Option 7: Require the Board of Investments to negotiate with companies that invest Montana funds to require an office in Montana for the purpose of providing onsite review and discussion of venture-stage capital investments with Montana businesses.**

<p><b>Issues:</b></p>	<ul style="list-style-type: none"> <li>• The Board of Investments is required to operate under a prudent investor rule, which may mean that a negotiation to require one of its investment partners to have an office in Montana would result in the Board not getting the best investor with the best returns. (Same concern as mentioned in Option 6.)</li> <li>• An office in Montana may be underused because, for example, Montana does not have the deal flow that would prompt investors to voluntarily establish an office here.</li> <li>• The benefit of an office in Montana is that the person conducting reviews of equity financing would be able to provide knowledge about next steps, suggestions of contacts with firms in similar fields, and possibly financing.</li> <li>• Investment firms specialize, which means that a firm establishing an office in Montana is likely to staff the office with a generalist, although that person can refer to the company's specialists elsewhere.</li> <li>• Although an office would be required, any deal would still have to stand on its own, which means that the requirement for an office may be too heavy-handed if the same review is available on the current referral basis.</li> <li>• Advice from experts in the venture capital world on next steps and missing links is considered critical for businesses that are on the verge of entrepreneurial growth. Such advice may be available informally or may be available at a cost from private consultants. State involvement may be necessary at this stage but unnecessary when deal flow picks up.</li> </ul>
<p><b>Costs:</b></p>	<p>The state may have to sweeten the management fees to encourage an in-state office, which means that the state ultimately would get a somewhat lower return on its investments in exchange for possible venture capital access for companies in Montana. If the arrangement produced economic growth in Montana, the lower return may be offset by increased income tax and property tax payments.</p>

**Summary**

Montana has long been active in various forms of economic development. To date, most of these activities have provided assistance to local governments, the University System, or businesses in the form of grants or loans or some form of tax credits. In addition, certain industries, such as agriculture and tourism, have benefited from specific funding allocations. In comparison with other states, however, Montana's economic picture looks grim--particularly as reflected in its 50th place ranking for average annual wages among workers who are not self-employed<sup>20</sup> or even in the most recent U.S. Bureau of Economic Analysis report indicating Montana is 44th among the states for per capita personal income.<sup>21</sup> Two questions asked in this

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<sup>20</sup>Montana has a high number of self-employed. Their wages or salaries are not reflected in the U.S. Bureau of Labor Statistics annual wages by state for 2002. See <http://www.bls.gov/cew/home.htm>.

<sup>21</sup>Bob Anez, "State income growth twice national average", *Helena Independent Record*, 4-28-04.

report are: Does Montana need to take additional action to spur economic growth, and, if so, what options might be most timely and beneficial? The Ad Hoc Working Group on Economic Development and Venture Capital has suggested that the answer is "yes, Montana does need to take additional actions". The group suggested a variety of options that range from no-cost recommendations for networking activities to be carried out in the executive branch to directives for revising how existing state funds are spent to boost economic growth. Other groups, specifically a Shared Leadership for a Stronger Montana Economy, will be proposing a variety of changes to boost economic development in Montana. The ad hoc working group confined its reviews primarily to capital formation and financing assistance rather than regulatory or educational suggestions for change. The group proposed consideration of the following options:

- maintain the status quo;
- modify existing programs to improve program delivery and sustainability;
- develop new incentives for investing, including tax credits, through either a Fund of Funds, a CAPCO, or an approach targeted at certain investors (including angel investors);
- require the Board of Investments to assign a portion of the coal tax trust fund or public pension funds to investment companies willing to invest more directly in Montana businesses. (Using a portion of the coal tax trust fund for equity investments would require a constitutional amendment.)
- direct the Board of Investments to negotiate contracts with companies handling certain Montana funds to have an office in Montana and review equity financing requests from Montana businesses.

The options are not mutually exclusive, although some may require more upfront investment by the state than others. Each has its costs, either direct, because the program continues grant-based financing, or indirect. A series of principles for financing economic development have been offered, at the suggestion of the ad hoc working group, in the midsection of this report to help retain the focus on which options best reflect which policies. These policies include:

- requiring transparency in funding;
- requiring joint support for a project so that the state is not the sole financier;
- relying on private-sector participation in managing economic development investments;
- requiring some recognizable return to the state for economic development financing programs; and
- apportioning economic development risk to the whole state when appropriate.

Selection of policies and options appropriate to Montana may reflect actions taken in other states and may improve Montana's prospects as it competes in a global economy. Recognizing the state's strengths and weaknesses is important. Good policies that stay in place long enough to build a record of success also will help long-range business planning. Just as policymakers do not want fly-by-night operators taking inappropriate advantage of Montana programs, neither does business want a fly-by-the-seat-of-the-pants policy that cannot stand the test of time or the market.

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