

New England

BUSINESS



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REVIEW

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Part II, State Loans and Loan Guarantee Programs

New War Between the States

In Part I of this series (October, 1963), the Business Development Corporation movement was described as the first of the "Blue" industrial development weapons. In effect, this typically Yankee movement represents an extension of the commercial banking system in order to pool greater risks. While primarily aimed at furthering state economic development, the movement was also an attempt to stem the development of direct and indirect credit programs by government.

Although useful and successful as a supplier of risk money, the movement has not completely succeeded in warding off direct state loan programs. In fact, states as Yankee as they come — Maine and New Hampshire — under pressure of slow economic growth have yielded to the use of state money and credit for industrial loans.

The use of public money for such private purposes is not new. In fact, defaults

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on state and municipal loans in the 19th century led many states to enact specific constitutional prohibitions against such use of public funds. As the competitive war between the states has grown more intense, however, many of these prohibitions have been dropped. At present the financial impact of state loans and loan guarantees is relatively insignificant. Still, some aspects of the state direct loan programs are potentially dangerous for reasons discussed below.

Industrial Building Authorities

An industrial building authority is essentially a state-sponsored loan insurance program for industrial buildings. In principle it is quite similar to the FHA insurance provided by the Federal Government for home loans. The state authority insures a loan ranging up to 90 percent of the land and building costs. The loan itself is placed with some private lender such as a bank or insurance company. To back the loan, the state pledges its full faith and credit and usually provides a reserve fund for claims in the case of a default.

Loan insurance programs now exist in seven states. Collectively, they have only 15 years of experience. So far no losses have occurred. Two defaults did occur in Maine, but both buildings were soon leased at terms covering the defaulted principal and interest. Some critics have been disturbed because of the state's contingent liability resulting from such a building authority. Judging from past experience, however, this risk does not appear significant. Almost all the programs have the security of a first mortgage position on tangible industrial property distributed throughout the state. Moreover, while most of the firms do not have prime credit ratings, their leases provide additional security. Barring a major depression it seems unlikely that most programs will become continually dependent on state funds.

The actual cost of this insurance is borne primarily by the borrower through a $\frac{1}{2}$ to 1 percent charge on outstanding balances. This revenue is usually enough to cover the direct administrative charges and to add to the fund. Sometimes administrative costs are absorbed by the respective state industrial development agencies until sufficient volume warrants a full-time staff. The board which actually reviews the application is made up of bankers and other interested citizens who serve without pay.

Excluding the insurance fee, interest charged by the lender ranges from 5 to 6 percent. The upper rate is thus $\frac{3}{4}$ of a percent higher than FHA home mortgage loans which are of longer average duration. When the service charge is added to the basic interest rate, the total cost to the borrower is between 6 and $6\frac{3}{4}$ percent. Altogether the cost of this financing is slightly higher than conventional bank mortgages.

In well-established programs the insurance fee has been large enough to cover administrative cost and to help build the reserve fund. The riskless nature of the loan usually permits the bank to lower its interest charge to at least partially offset the service fee. It is conceivable that the service charge in the future could be reduced to $\frac{1}{4}$ percent at least for some loans. At such a low rate, some banks might use this program extensively if only to be exempt from the legal restriction limiting the amount of a bank mortgage loan to two-thirds or three-fourths of the assessed value of land and buildings.

Historically banks have shied away from mortgages on industrial building especially if the resale value of the property was at all questionable. A by-product of this program is that the bankers' resale problem is reduced. Compared with similar uninsured loans, those that are insured are easier to sell and therefore more desirable assets. This feature may make such insurance an extremely significant form for financing industrial building.

A state program for industrial mortgage insurance makes risk credit available to some capital-shy firms with good income prospects. Any increase in the efficiency of the state's industrial plant enhances its over-all competitive position. With little encroachment on public funds such a program may stimulate a large amount of new industrial building in the future. A similar program, the Federal home mortgage insurance plan, encouraged new home building of almost revolutionary proportions.

Two New England states, Maine and Rhode Island, are the pioneers with a combined 11 years

New England Experience

of experience in the program. They have extended insurance for loans of almost \$26 million, representing most of the loans insured to date in this program.

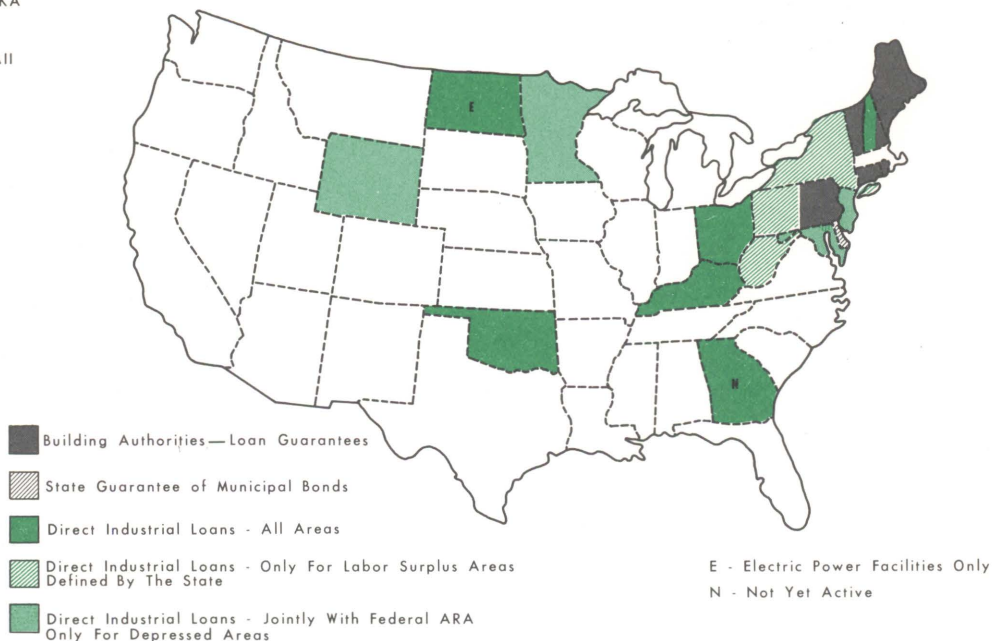
If their experience is typical, building insurance is primarily useful for established firms within the state employing fewer than 200 workers. However,

STATE DIRECT LOAN AND LOAN GUARANTEE PROGRAMS

ALASKA



HAWAII



the use of one-fourth of the insured loans for relocation and expansion of out-of-state firms shows the program's ability also to attract industry into the state. Since their start, the programs have helped these two states create or sustain about 7,200 jobs.

Connecticut's recently activated building insurance program indicates the usefulness of this type of insurance in a relatively prosperous state. If the present rate of application and approval continues, the responsible officials feel that the initial authorization of \$25 million may be fully used before the end of its first year of activity. Such volume represents substantial modernization of plant facilities for small and middle-size firms.

Connecticut's program has the added feature of varying the service charge according to the degree of risk determined by both the firm's credit rating and the plant's resale potential. This important innovation may provide for broader use of the program.

Almost all state development officials in New England are pleased with their handiwork. The initial response to Connecticut's program surpassed the most optimistic expectations of its officers. Maine's representatives call the building authority

"extremely effective—the backbone of Maine's program." Rhode Island leaders agree that it is a "significant contribution."

One criticism of the building authority movement is that in general initial appropriations have been too small to provide adequate reserves for possible defaults. Maine's current reserve covering 1/17 of outstanding loans and 1/40 of maximum insured loans comes closest to being adequate. Reserves theoretically should be sufficient for most short run contingencies without resorting to special bond issues or emergency appropriations. Without adequate reserves, insurance programs may become unduly conservative in order to protect themselves. Also they may meet with less than full acceptance by the banking community.

One Reservation

Direct Loan Programs

Interstate competition for industry has led some states to use state money extensively in direct loan programs as opposed to loan insurance programs. Pennsylvania, New Hampshire, Oklahoma, and Kentucky account for most of the experience to date.

Moreover, such giant industrial states as Ohio and New York are just entering the field.

In twenty years of collective experience, industrial loan programs in 11 states have provided \$60 million of long-term loans for industry, primarily in depressed areas, and have incurred only small losses—.05 percent of the total above.

Although these programs were first directed to depressed areas, many now encompass the whole state. If the states continue to vie with each other, they may start offering interest-free loans to encourage industrial development. The next step would be outright capital gifts. Conceivably states might find themselves deeply involved in the banking business with most industry demanding the subsidy.

Furthermore, state direct loan programs are partially dependent on artificially low interest rates made possible by the general revenue of the state or tax exempt securities. When a state lends at its long-term borrowing cost, its tax exempt borrowing privileges are transferred to private industry. If state direct loan programs were to be greatly expanded, the result would be a large increase in the volume of tax exempt securities. It is highly unlikely that the Federal Government would tolerate indefinitely another inroad on its tax base. Even without federal intervention, a large increase in the supply of tax exempts would mean that the states would have to pay more for the money they borrow.

Most states, recognizing the potential dangers of the use of state credit, have built into the programs some restrictions which limit the use of state credit for industrial purposes. However, these restrictions have not been adopted in every state, and they could be eroded through the force of interstate competition. Unless minimum safeguards are adopted and maintained by most states, federal legislation may become necessary. Some highly desirable limitations for state direct loan programs are:

Needed Safeguards

Depressed Areas Only—The use of direct loans by a state should be limited to its less prosperous areas. Of the 14 states using this development tool, only eight have included this provision.

There seems little justification for extensive use of state funds to aid industrial growth in relatively healthy areas. In those localities, the building authority form of insurance could provide feasible projects with ample funds at reasonable rates, such

as 6 or 6½ percent.

Several state programs are in fact designed simply to supplement the Federal Redevelopment program for direct loans to industries in depressed areas. These state programs usually provide half of the needed state and local share where the depressed communities have difficulty in meeting their participation requirements (10 percent).

Minimum Interest Rates—Interest rates should be sufficient to cover both the state's cost of borrowing and the administrative costs of the lending program. Some states charge less. Pennsylvania and New York charge as little as 2 or 2¾ percent for direct loans in depressed areas even though the actual or expected cost of money to the state is 3 percent or more.

A minimum rate providing a floor against the forces of interstate competition should be established. This should be high enough to cover costs and make loans self-liquidating. A rate of 3½ or 4 percent would minimize the danger to state tax funds, but at the same time maintain the advantage of offering higher risk loans at lower cost than can be provided by commercial lenders.

No Alternative Source—State loans should be extended only when financing is not available from conventional financial institutions. Where financing by private sources is adequate, there is no need to use public tax funds. Unfortunately, six states have not included this clause, probably the most important of all safeguards. Where the financial needs can be serviced through the cooperation of several banks jointly, the use of state funds should be withheld, even though it is to the financial advantage of the borrower to obtain state funds. This omission might be extremely dangerous except that many states without this provision have included a requirement for bank participation.

Bank Participation—The requirement that banks participate in state loans is widespread. The range of participation varies from 10 to 50 percent among the states. Typically, the bank receives the first mortgage position for this participation. New Hampshire and Hawaii are the only states where the regulations do not require some form of bank participation. This safeguard enables the directors of the state loan program to take advantage of the experience of commercial lenders. It also calls the attention of commercial lenders to the need for particular financing.

Limited to Land and Buildings—State loans should be limited to land and buildings. Nine states also provide long-term loans for machinery and equipment. If a state underwrites the entire cost of a project, it assumes most of the risks and leaves the “owners” virtually no financial liability. Such a situation hardly encourages sober management judgment. Furthermore, much equipment is useful only for specific purposes, with little resale value, thus raising the risk to state funds. A possible alternative to limiting loans to land and buildings is a maximum of 75 percent of the cost of land, building, and equipment.

Community Participation—A common, though perhaps not as essential, requirement is community participation. This requirement varies. In ten states the local community must provide from 5 to 20 percent of the loan. In one state the local foundation is merely a legal mechanism to administer the loan. Only three states have omitted a provision for local support.

Such a requirement moderates the extent of a state loan program by providing another “board of review.”

Despite these reservations, it cannot be denied that direct loan programs are effective tools for the states which have adopted them. Like the building authority, the direct loan program has been used primarily by established firms within the state employing fewer than 200 workers. Another similarity is the proportion of firms from out-of-state (about one-quarter), using the direct loan program. However, this program financed significantly more newly established firms—40 percent of all loans compared to only 2 percent for building authorities. This might indicate that the direct loan program has taken more inherent risks. In addition, a greater proportion of direct loans were made to firms with 200 to 500 employees.

The most developed program is the Pennsylvania Industrial Development Authority (PIDA). Describing its achievements, a representative of the State’s Department of Commerce said:

As of April 1963, PIDA made 286 loans of \$38,006,445 on projects to cost \$107,966,389; anticipated employment is 45,454 and anticipated payroll is \$171,108,046. These loans are primarily for relocations and expansions and many

of them would not have taken place in Pennsylvania were it not for PIDA.

This program is limited to Pennsylvania’s less prosperous areas. As a supplement, another program for statewide building insurance has been introduced this year. This combination has much to recommend it to states interested in promoting industrial development through direct loan programs without becoming overextended.

Perhaps the most unorthodox use of state funds for industrial development purposes has taken place in New Hampshire. State funds there were used not only for industrial parks but also for speculative building—that is, building without specified tenants. Although the program has been remarkably successful (of the 7 buildings put up, 6 were eventually filled) the authority has recently adopted a more conservative approach. In the future, emphasis will be on building to meet the needs of a specific industrialist. Furthermore, loan guarantees will be emphasized in lieu of direct loans of state funds.

Primary Significance

State development financing devices are primarily significant for making industrial building projects possible, rather than providing lower than average interest rates. There is little justification for providing money at artificially low rates. It is doubtful that saving of even 2 or 3 percent on interest cost has much influence in determining the location of a plant, other factors considered.

By providing a mechanism for the pooling of high risk loans, a state can make a real contribution to both the state and the national economy through encouraging innovation and greater efficiency. Even if adopted in all 50 states, the building authority would contribute to economic growth. This is not necessarily true of the state direct loan program. Without necessary safeguards, interstate competition may bring about undesirable changes in our financial and government institutions.

The New England Business Review is produced in the Research Department. Edwin C. Gooding was primarily responsible for the article, “New War Between the States — Part II, State Loan and Loan Guarantee Programs.” Supplementary material is available on request.

New England's Inconstant Growth Rate

The rate of growth of the New England economy has slowed down this year from its pace in the 1960-1962 period when its increase in personal income matched the Nation's. Estimates by *Business Week* for the first nine months of this year indicate that the region's personal income was up only 3.0 percent over the same period last year. This compares with a 5.2 percent increase in the Nation.

Regional economic indicators other than personal income also show little growth. During the first ten months of 1963, total nonagricultural employment in New England was virtually unchanged from the same period last year. In contrast, the Nation had a 2 percent rise.

With little change in employment and a stable workforce, the region's seasonally adjusted unemployment rate has declined only slightly so far this year, from 5.6 percent last January to 5.5 in October. In the Nation the rate declined from 5.8 percent to 5.5 percent over this period.

To be sure, some types of regional activity are holding near their previous highs or forging ahead. Department store sales so far this year are running 4 percent above last year's level. Construction contracts, after a spectacular advance of 17 percent in 1962 over 1961, increased by 3 percent through October from the corresponding period last year. When all types of activity are aggregated, however, as in the income and employment data, the region's growth is clearly less than a year ago.

The Massachusetts Problem

To a considerable extent the region's slower growth this year reflects the relatively static situation prevailing in Massachusetts. The other New England states as a group show an advance over last year well above that of Massachusetts in most economic indices. Personal income is up only 1 percent in Massachusetts while the rest of New England shows a 5.0 percent rise, close to the Nation's 5.2 percent. This lag in Massachusetts is due chiefly to a slackening in employment. So far this year nonagricultural employment in the State has declined one-half percentage point, whereas the other five New England states show a 1 percent gain.

The weakness in the Massachusetts' economy is also reflected in its unemployment rate, which this

year is averaging a half percentage point above its level last year at 5.8 percent of the workforce.

The remainder of New England, on the other hand, is averaging 5.3 percent, the same rate as last year.

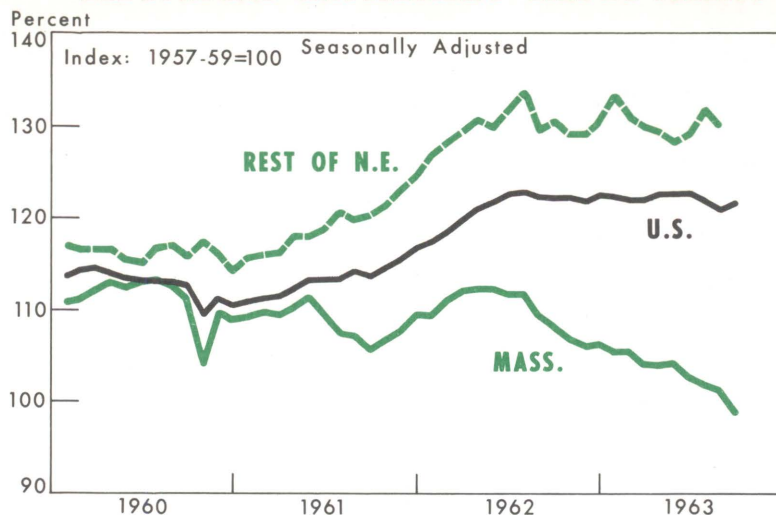
The rise in unemployment is spread throughout Massachusetts. Except for Boston, all the State's major labor markets show an increase in unemployment through July of this year. Unemployment rates have averaged 8.2 percent, compared to 7.5 percent over the same period last year.

To discover the underlying causes of the slowdown in Massachusetts, it is necessary to examine the component sectors of the economy. So far this year nonmanufacturing employment has continued to advance with jobs up more than 1 percent over 1962 levels. This, however, is still less than half the rate in the Nation. Growth in this sector has no doubt been dampened by the decline which has taken place in manufacturing. This year until now employment in manufacturing has averaged 3 percent lower in the State than last year. This has occurred while the rest of New England was maintaining its year-ago level.

The trend of manufacturing employment in Massachusetts began to fall and to diverge from the rest of the region and the United States at the beginning of 1962. Ever since, the gap has widened steadily. In comparison with the 1957-1959 period, Massachusetts' level of employment in soft goods industries was consistently lower than its neighbors' and the Nation's over the 1960-1963 period, but the level in the durable goods sector was high enough to offset this through 1961. After that, however, employment in hard goods began to decline. Now it is lower than the average for the remaining states of the region and for the Nation.

Well over half the employment drop in durable goods has occurred in the electrical machinery industry, where electronics production is concentrated. Employment there shows a 7 percent decline through October of this year compared to the corresponding period a year ago. In the Boston area alone, the industry's decline represents a loss of about 5,300 jobs. As noted in the November Business Review, new orders for the industry have been slow in coming; by the end of September they were down by

ELECTRICAL MACHINERY EMPLOYMENT



over 3 percent from 1962 figures. All other durable goods industries except for instruments have also registered some employment loss over the period.

Over one-half of Massachusetts' durable goods employment is concentrated in industries, such as electrical machinery, which are highly dependent on expenditures for defense and space exploration. The State's share of defense prime contract awards fell by a percentage point between fiscal 1962 and 1963 to 4.2 percent of the national total. This meant an absolute decline of \$250 million in these awards for Massachusetts. These awards do not include subcontracts received by firms in the State. However, previous studies have indicated that the trends of subcontracts and prime contracts tend to move together.*

In Massachusetts' nondurable goods industries only food and printing show employment gains this year over last. The largest employment decline this year has occurred in leather and shoes. Employment through October of this year was averaging 9 percent, or more than 3,000 jobs, below the comparable period last year. This is in contrast to the rest of New England, where employment in leather and shoes shows virtually no change from year-ago levels.

This pattern of shoe employment is a reflection of production levels within the region. Shoe output by Massachusetts firms is 5 percent below last year, while firms in the rest of New England are main-

*See, "Military Expenditures in New England," Research Report No. 14 (1961), Federal Reserve Bank of Boston.

taining their year-ago production levels.

The Future

New England's prospects next year depend to a large extent on whether the Massachusetts' economy begins to show improvement over its relatively static position of the moment. Some signs indicate that the State's setback may be only temporary.

According to a survey made by this Bank,

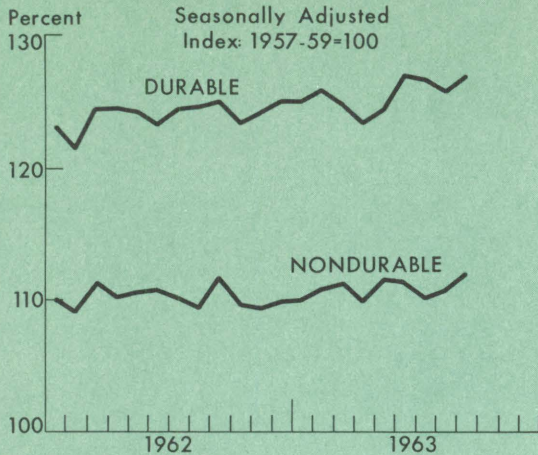
Massachusetts' manufacturers are spending 13 percent more for new plant and equipment this year than last. This is despite the 5 percent cutback in outlays by the State's electrical machinery producers. The gain is more than double that expected for New England as a whole and for the Nation.

Moreover, preliminary spending plans for 1964, as formulated in August and September of this year, indicate that eight manufacturing industries, including transportation equipment, instruments, paper, and printing, expect to increase outlays in Massachusetts.

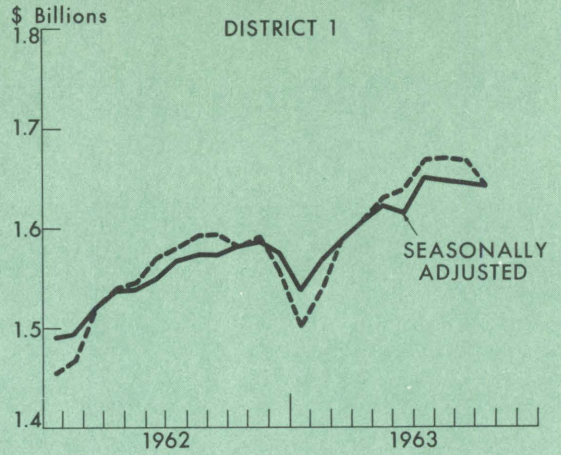
Three-fourths of the respondents expect their sales to improve next year, while only 7 percent foresee a decline.

The ability of Massachusetts' manufacturers to obtain increased defense and space business will have much to do with the realization of these expectations. A study by the Greater Boston Economic Study Committee found that almost one-half of sales by the electronics industry in that area goes to the Federal Government, while less than an eighth is for households and other private consumers. This points up a serious problem for the State, and for the region as a whole. Industrial composition has changed from a concentration in textile production to one in space and defense related industries which rely to a large extent on government orders. This, of course, can lead to sharp fluctuations in growth. A wider diversification of markets among the government, industrial, and consumer sectors would be helpful in reducing these wide swings.

NEW ENGLAND MANUFACTURING



COMMERCIAL AND INDUSTRIAL LOANS



MANUFACTURING INDEXES (seasonally adjusted) 1957-59 = 100

All Manufacturing
Nonelectrical Machinery
Electrical Machinery
Transportation Equipment
Textiles, Apparel, Leather
Textiles
Apparel
Leather
Paper

NEW ENGLAND

	pOct. '63	Sept. '63	Oct. '62
122			
130			
130			
148			
105			
106			
111			
n.a.			
118			

UNITED STATES

	Oct. '63	Sept. '63	Oct. '62
127			
131			
134			
131			
122			
121			
129			
n.a.			
128			

BANKING AND CREDIT

Commercial and Industrial Loans (\$ millions) (Weekly Reporting Member Banks)
Deposits (\$ millions) (Weekly Reporting Member Banks)
Check Payments (\$ millions) (Selected Cities)
Consumer Installment Credit Outstanding (index, seas. adj. 1957 = 100)

NEW ENGLAND

Percent Change from:

	Oct. '63	Sept. '63	Oct. '62
1,644			
5,207			
12,958			
139.8			

UNITED STATES

Percent Change from:

	Oct. '63	Sept. '63	Oct. '62
36,231			
135,284			
200,643			
154.6			

DEPARTMENT STORE SALES

(index, seas. adj. 1957-59 = 100)

112	113
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EMPLOYMENT, PRICES, MAN-HOURS & EARNINGS

Nonagricultural Employment (thousands)
Insured Unemployment (thousands) (excl. R.R. and temporary programs)
Consumer Prices (index, 1957-59 = 100)
Production-Worker Man-Hours (index, 1957-59 = 100)
Weekly Earnings in Manufacturing (\$)

3,839	58,320
112	1,325
108.7	107.2
97.3	104.4
92.40	100.53

OTHER INDICATORS

Construction Contract Awards (\$ thous.) (3-mos. moving averages Aug., Sept., Oct.)
Total
Residential
Public Works
Electrical Energy Production (4 weeks ending Nov. 2, 1963) (index, seas. adj. 1957-59 = 100)
Business Failures (number)
New Business Incorporations (number)

212,579	4,027,184
82,900	1,899,898
31,108	694,879
135	143
n.a.	n.a.
975	16,741

p = preliminary

n.a. = not available

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