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RESOURCES AND OPERATING PROCEDURES
LIMIT THE POTENTIAL IMPACT OF
THE ECONOMIC DEVELOPMENT ADMINISTRATION'S
BUSINESS DEVELOPMENT LOAN PROGRAM

Department of Commerce

UNITED STATES
GENERAL ACCOUNTING OFFICE

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UNITED STATES GENERAL ACCOUNTING OFFICE
WASHINGTON, D.C. 20548

COMMUNITY AND ECONOMIC
DEVELOPMENT DIVISION

The Honorable John W. Eden
Acting Assistant Secretary for
Economic Development
Department of Commerce

Dear Mr. Eden:

We have completed a limited review of the Economic Development Administration's Business Development Loan Program. This report contains recommendations which we believe will improve the effectiveness of this program.

We are sending copies of this report to the Assistant Secretary for Administration, Department of Commerce; Deputy Director, Office of Audits, Department of Commerce; and the Director, Office of Business Development, Economic Development Administration.

We would appreciate your comments on our findings and recommendations, including any actions you take or plan to take.

Sincerely yours,

John Landicho

John Landicho
Associate Director

C o n t e n t s

ABBREVIATIONS

EDA	Economic Development Administration
GAO	General Accounting Office
OEDP	Overall Economic Development Plan

REPORT TO THE ASSISTANT SECRETARY FOR ECONOMIC DEVELOPMENT DEPARTMENT OF COMMERCE

RESOURCES AND OPERATING PROCEDURES LIMIT THE POTENTIAL IMPACT OF THE ECONOMIC DEVELOPMENT ADMINISTRATION'S BUSINESS DEVELOPMENT LOAN PROGRAM

D I G E S T

The Economic Development Administration's Business Development Loan Program is one of several financial mediums provided for under the Economic Development Act of 1965. The objective of the act is to create new jobs in areas of substantial and/or persistent unemployment and underemployment. This report identifies matters which limit the impact of the Business Development Loan Program in meeting this objective.

Over the decade since the creation of the Economic Development Administration appropriations to the Business Development Loan Program have remained relatively constant while the number of areas eligible for program assistance has doubled. The net effect has been the gradual decline in the percent of eligible areas receiving program assistance. In fiscal year 1976, we estimate the program will assist only 2.5 percent of the eligible areas.

Operating procedures overemphasize the program's role in influencing corporate location decisions and do not provide sufficient financial analysis to assure limited program resources are directed toward economic development and employment opportunities which in all likelihood would not have been created without program assistance.

We recommend the Assistant Secretary for Economic Development review and revise existing operating procedures to better assure loans are made only where there is sufficient evidence that the proposed industrial expansion is largely dependent upon program assistance.

Administrators of the Business Development Loan Program agreed, due to the magnitude of the problem to which the agency was mandated to address and the comparatively limited level of funding, the program's overall impact has been minimal. These officials agreed that EDA loans were not the primary factor influencing business location decisions, however, they believe program financing allows a company to expand to a greater degree or to expand sooner than they would otherwise have been able to do.

CHAPTER 1

INTRODUCTION

The Economic Development Administration (EDA) within the Department of Commerce was established pursuant to the Public Works and Economic Development Act of 1965 (42 U.S.C. 3121). According to the act, EDA's primary purpose is to create new jobs in areas of substantial and/or persistent unemployment and underemployment. Financial assistance provided in the act includes:

--Public Works Grants and Loans - used to assist redevelopment areas by providing vital public facilities necessary for the successful establishment or expansion of industrial or commercial facilities.

--Business Development Loans and Guarantees - used to provide special incentives, such as low-cost loans and working capital loan guarantees, to encourage business and industry to build or expand operations in redevelopment areas.

--Technical Assistance Grants - used to evaluate and/or shape specific projects and programs for economic development.

--Planning Grants - used for initiating planning, and programming economic development activities.

--Special Economic Development and Adjustment Assistance Grants - used to help State and local areas meet special economic adjustment problems resulting from severe changes in economic conditions.

This report assesses the potential impact of business development loans to industrial and commercial activities in meeting the agency's aforementioned purpose. Available resources and procedures affecting their allocation were the basis upon which potential impact of business development loans was assessed.

Financial assistance to private businesses, known as the Business Development Loan Program, is authorized by section 202 of the act. Until fiscal year 1975, such assistance was restricted by law to direct loans for the purchase or development of land and facilities including machinery and equipment and working capital guarantees. Amendments to section 202 in fiscal year 1975 (Public Law 93-423) provided new authority to make direct loans for working capital and to guarantee loans made by private lending institutions and to guarantee rental payments of leases for buildings and equipment. The amendments also removed a restriction that working capital guarantees were available only in connection with direct loans.

The primary goal of the Business Development Loan Program is the creation of job opportunities in redevelopment areas. Redevelopment areas are those generally characterized by substantial unemployment and/or low median family income as defined by title IV of the act. The effectiveness of the program is directly related to EDA's ability to cause companies to locate or expand in redevelopment areas.

Historically, program emphasis has been on direct loans. Direct loans may be made for periods up to 25 years at a rate of interest based on the Federal borrowing costs. According to section 202, however, no loan is to be extended unless the financial assistance applied for is not otherwise available from private lenders or from other Federal agencies on terms which in the opinion of the Secretary of Commerce will permit the accomplishment of the project.

Since the program's inception through December 31, 1975, approximately 420 direct loans, totaling $428 million and approximately 100 guarantees, totaling $142 million have been authorized.

SCOPE OF REVIEW

During our review, we examined and assessed EDA's procedures critical to the selection of business loan recipients. We made a historical comparison of total program resources relative to the number of redevelopment areas eligible for program assistance.

We reviewed the legislative history of the Economic Development Act and the evolution of implementing procedures applicable to the administration of the Business Development Loan Program. We examined

EDA's loan processing files and documentation for 8 of the 16 loans made in EDA's Midwestern Regional Office between July 1, 1970, and June 30, 1975. Because processing and approval of all loans is centralized in EDA's headquarters offices these loans exemplify EDA's operating procedures with respect to direct loans. In addition, we examined available documentation pertaining to two loans approved but not disbursed and two current projects pending before EDA.

Our field work was done in the Washington, D.C. headquarters of EDA and at its Midwestern Regional Office, Chicago, Illinois. In addition we visited offices of selected corporations that received EDA loans.

CHAPTER 2

CONTEXT IN WHICH TO CONSIDER THE BUSINESS DEVELOPMENT LOAN PROGRAM

The primary purpose of this chapter is to relate resources of EDA's Business Development Loan Program to the number of areas eligible for program assistance. A secondary purpose is to provide a better perspective for understanding the ramifications of shortcomings in the program's operating procedures discussed in chapters 3 and 4. Discussed in the chapter is the criteria an area must satisfy to be eligible for EDA assistance; changes to that criteria which have contributed to the increase in redevelopment areas; and a historical account of program resources relative to redevelopment areas they are intended to assist.

In the decade since the creation of EDA the number of redevelopment areas eligible for the various types of financial assistance provided in the act, including business development loans and guarantees, has doubled. However, overall appropriations to EDA and specific appropriations to the Business Development Loan Program have remained relatively constant during this period. The net effect has been a gradual decline in the percent of redevelopment areas receiving business development loan assistance each year until in fiscal year 1976, we estimate the program will directly assist only 2.5 percent of the redevelopment areas.

CRITERIA FOR AREA QUALIFICATION/ DESIGNATION

To qualify to receive basic forms of assistance provided by EDA, including business development loans and guarantees, an area must meet one of the requirements set forth in title IV of the act. The term "area" includes counties, Indian reservations, labor areas, and census divisions of urban communities. The specific requirements for qualifications delineated in title IV are outlined below:

--Areas experiencing at least 6 percent unemployment for various time periods depending upon how much greater the area's unemployment rate was above the national rate, i.e., if 50 percent to 75 percent above the national average, the rate must have been experienced for 3 of the preceding 4 years and must have averaged at least 6 percent.

--Areas where median family income was 50 percent or less of the national average on the basis of the most recent available statistics.

--Indian reservations, trusts, or land areas within certain limitations.

--Areas experiencing an unusual and abrupt rise in unemployment in the last 3 years or anticipating such a rise in the next 3 years caused by the loss, curtailment, or closing of a major source of employment for the area if at the time of the request the unemployment rate exceeds or is expected to exceed the national average by 50 percent or more.

--Areas, regardless of whether they are a political subdivision, if they exhibit any of the following conditions:

a. has a large concentration of low income persons;
b. is a rural area having substantial out-migration;
c. has substantial unemployment; or
d. has experienced an actual, or is threatened by, a sudden rise of unemployment.

--Areas where per capita employment has declined significantly during the previous 10 years.

--Areas which experienced substantial unemployment during the preceding calendar year. Substantial unemployment is currently defined as 6 percent or more.

After an area is determined qualified, it must submit an Overall Economic Development Plan (OEDP) to EDA in order to become a designated redevelopment area and actually be eligible for EDA program assistance. The OEDP must provide a realistic development program that can be implemented in an effort to promote the area's economic progress; improve community facilities and services; and serve as a basis for continued economic development planning.

Major changes to area qualification criteria

Since the passage of the act there have been two major amendments affecting area eligibility under the title IV criteria. The effect of both amendments has been to increase the number of areas eligible for EDA assistance.

The first amendment, Public Law 91-304, approved July 6, 1970, instituted a moratorium on de-designation of areas after May 1, 1970, and before June 1, 1971. The moratorium has been extended through June 1, 1976. At the time the law was passed, members of both the Senate and House Public Works Committees, shared the opinion that income levels and unemployment statistics were unreliable when applied to rural areas to determine their eligibility for program assistance. When the amendment passed, EDA had identified 96 counties to be de-designated. At the end of fiscal year 1975, EDA identified approximately 500 areas that were still eligible for assistance on the basis of the moratorium.

On May 10, 1971, we issued a report to Congress entitled, "More Reliable Data Needed as a Basis for Providing Federal Assistance to Economically Distressed Areas." In that report we disclosed that the unemployment and income data used by the EDA in determining eligibility of rural areas were not current and were of questionable accuracy. While the Department of Labor substantially agreed with the findings, and agreed to consider the recommendations made, the problem of accurately delineating economic distress in rural areas persists today. Further, it continues to be a source of congressional concern as evidenced by the introduction on December 4, 1975, of H.R. 10990 to establish a commission to develop measures for improving the method of collecting and analyzing national employment and unemployment information and statistics. In spring 1976, the Bureau of Labor Statistics prepared an outline for a planned review of the Bureau's employment and unemployment statistics to be performed by an impartial, outside group of experts.

The second amendment, which was incorporated into Public Law 93-423, passed September 27, 1974, added a new qualification provision to title IV. This provision provided that areas experiencing substantial unemployment during the preceding calendar year would be eligible for EDA assistance. As previously stated substantial unemployment has been defined as 6 percent or more.

Prior to this amendment, for areas experiencing substantial unemployment to be eligible for business development loans and guarantees, the area's unemployment must also have been persistent. To satisfy the requirement of persistency the unemployment rate must have exceeded the national average for a certain number of years dependent upon severity.

Near the end of fiscal year 1975, approximately 485 areas qualified for EDA assistance on the basis of substantial unemployment. In addition, EDA officials estimate that when current unemployment figures become available, a substantial number of the approximately 500 areas eligible for assistance because of the moratorium will also qualify based on substantial unemployment.

Doubling of areas eligible for EDA assistance

At the beginning of fiscal year 1967, there were approximately 660 designated redevelopment areas eligible for business development loan assistance. By the beginning of fiscal year 1976, this number had more than doubled to 1,600.

While the amendments to the title IV criteria have resulted in an increase in the number of designated redevelopment areas, an underlying cause for the increase has been the rise in the nation's unemployment rate since the passage of the act. In 1965 the nation's unemployment rate averaged 4.6 percent while in 1975 the average was 8.5 percent, 40 percent above the level necessary for areas to qualify for EDA assistance.

PROGRAM RESOURCES RELATIVE TO REDEVELOPMENT AREAS

For the 10-year period, fiscal year 1966 through fiscal year 1975, annual appropriations to the Business Development Loan Program have consistently averaged $50 million with the exception of fiscal years 1974 and 1975 when they fell to $20 million and $17 million respectively. In fiscal year 1976, $58 million was appropriated to the program; however, $17 million must be used to provide adjustment assistance to firms for injury caused by import competition as defined in the Trade Act of 1974 (Public Law 93-618).

While resources for the Business Development Loan Program have remained relatively stable, the significant increase in redevelopment areas had reduced the program's impact when measured using a ratio of the number of redevelopment areas potentially assisted to the number of areas eligible for such assistance. To illustrate, for fiscal years 1967 through 1968, there were an average of approximately 700 designated redevelopment areas eligible for program assistance. During this same period an annual average of 59 direct loans were made. Assuming maximum coverage, no more than one loan to any designated redevelopment area in the course of a year, which a program official advised was generally indicative of disbursements, 8.5 percent of the areas could have been assisted in any one year. Comparable analysis for fiscal years 1969 through 1971 and 1972 through 1974, show a maximum potential for assisting 5.0 percent and 3.5 percent of the designated redevelopment areas respectively.

With unusually low program funding in fiscal year 1975, approximately 1.4 percent of the designated redevelopment areas could have been assisted. Even with more traditional levels of funding in fiscal year 1976, and also considering the new program authorities provided in Public Law 93-423, which were briefly mentioned in chapter 1, we estimate that only 2.5 percent of the 1,600 designated redevelopment areas will directly benefit from the program in fiscal year 1976.

CHAPTER 3

PROCEDURES OVEREMPHASIZE EDA'S

INFLUENCE ON CORPORATE LOCATION DECISIONS

The act authorizes the Secretary of Commerce to provide financial assistance to businesses when he determines that such assistance is not otherwise available from private lenders or from other Federal agencies on terms which will permit the accomplishment of the project.

We found that operating procedures used to evaluate the need for EDA assistance (1) overemphasize the agency's role in influencing corporate location decisions, and (2) do not provide adequate assurance that EDA financial assistance is necessary to accomplish the project. We perceive that operating procedures giving greater emphasis to assessing the firm's need for EDA financial assistance, would better assure business growth and the creation of job opportunities in redevelopment areas that would not otherwise have been accomplished without EDA financing. The nature of these changes is discussed in chapter 4.

CORPORATE LOCATION DECISIONS

While a firm may have sufficient funds to go ahead with a project, EDA's operating procedures provide for financial assistance to the firm as compensation for the disadvantages associated with locating in a redevelopment area characterized by high unemployment and low median family incomes. However, we found that corporate location decisions are primarily influenced by other determinants, and EDA loans have not significantly influenced business location decisions.

EDA operating procedures

EDA's policy since its inception has been to extend loan assistance to sizeable, often times multi-million dollar corporations, to induce these corporations to locate business projects in redevelopment areas. According to an EDA analysis of legislative intent, Congress did not impose constraints precluding loans to sizeable corporations in recognition that these enterprises could contribute significantly to the economies of depressed areas. This analysis points out that without the inducement of a long-term, low-interest loan, few such corporations elected under the Area Redevelopment Act of 1961 (legislation preceding and intended to accomplish essentially the same purpose as EDA) to locate in designated areas.

EDA's Business Development Manual contains the following procedural guidelines relating location to financing:

> "Where EDA is being asked to lend money either directly or indirectly into a large corporation, the applicant will ordinarily have its own funds available or will have access to non-Federal funds sufficient to finance the cost of the physical facilities. However, in most cases the applications are being submitted as a result of EDA's conscious effort to encourage established companies with substantial net worth to locate in EDA qualified areas as opposed to more cost competitive areas. Location of a project in EDA areas normally will impose some competitive disadvantages and added economic pressures on the operator. Because it is not EDA's intention to ask these companies to place themselves at a competitive disadvantage by locating in an EDA area, the Office of Business Development will accept applications from such a corporation provided it certifies that it would locate in another area with more favorable economic advantages if it were not for the benefits of the EDA financial assistance."

As stated above, EDA does require that applicants provide a letter certifying that they would locate in another area with more favorable economic advantages if it were not for the benefits of the EDA loan. This letter is to be included in the project file and the certification reviewed by EDA financial analysts for the reasonableness of the facts supporting the certification. We did not find in the cases reviewed that detailed analyses were made by EDA of the specific factors which influenced the location decisions, their relative weight, the altern tive locations considered, the rationale supporting the determination that the decision to locate in the EDA designated area was disadvantageous, or other information to show that EDA's loan was a primary determinant in the location decision.

Other factors influencing location

Although EDA's policy statements and guidelines acknowledge that large corporations will ordinarily have sufficient resources to finance proposed projects they do not give cognizance to the possibility that these corporations may normally find it advantageous rather than disadvantageous, to locate in particular areas. Furthermore, EDA guidelines do not discuss the large variety of factors--other than EDA loans--that generally are considered by business decision makers in selecting a location. These factors include but are not limited to: labor force availability, transportation requirements, raw materials and/or supplies, general proximity to markets, site location and development requirements, financial and other assistance, tax advantages, and general social and community amenities including employee housing availability.

We examined information bearing on location decisions associated with the 8 loans approved after July 1, 1970. In addition we examined 12 other location decisions made by these same companies in both redevelopment and nonredevelopment areas. We did not find that the EDA loans were a primary inducement or that the companies were induced for any reason to locate business facilities in areas which were economically or competitively disadvantageous. In fact, we found that the business location decisions were made because the locations were advantageous. In five of the eight approved loans the location decision was already made, and land, buildings or equipment purchased, or construction begun before applications were made for EDA funds.

In one case the location was decided upon as part of an overall corporate strategy in advance of the application for an EDA loan. The location was largely determined by such factors as proximity to the farmland, warehouses, and processing plants owned by affiliated companies. In another case the location decision was based in large part on proximity to the already established production plant, and other factors such as cost, space, and availability of an appropriate labor force.

Questionnaires soliciting businessmen's views in two recent GAO reports to the Congress showed that financial assistance was not rated as a highly significant factor in selecting a location. In one report1/, 19 out of 24 firms questioned did not rank financial assistance among the 3 main reasons influencing their location selection. In

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1/"National Rural Development Efforts and the Impact of Federal Programs on a 12-County Rural Area in South Dakota" (RED-75-288, Jan. 8, 1975).

the other report1/, comments of officials representing 62 businesses were obtained and financial assistance was listed seventh in order of importance among 13 factors influencing location decisions.

Studies performed by a consultant for two Federal agencies concluded that financial inducements were not generally effective in influencing location decisions by companies affiliated with large national corporations. One study pointed out that larger companies are located according to basic economic criteria deemed essential to the profitable operation of the business; major factors include proximity to markets and the availability, quality and cost of labor. Financial inducements, according to the report, were more important to small, struggling companies which did not have adequate internal resources and which apparently could not obtain resources in the private capital market either in amounts sufficient to meet their needs, or at rates that they could afford.

1/"Improving Federally Assisted Business Development on Indian Reservations" (RED-75-371, June 27, 1975).

CHAPTER 4

EDA OPERATING PROCEDURES DO NOT PROVIDE

ADEQUATE ASSURANCE THAT EDA

FINANCIAL ASSISTANCE IS NECESSARY

An EDA policy of directing the loan program toward companies which may have substantial net worth is based on a premise that large corporations who have or are able to obtain alternative financing should nevertheless be given EDA loans as compensation for locating in less than advantageous areas. As discussed in chapter 3, we found that EDA loans did not significantly influence corporate location decisions and that other factors such as labor force availability and proximity to markets, may be more important in determining site locations.

Since EDA financing has not been critical in the location decisions examined, we believe the agency should critically evaluate the actual need a business has for their assistance rather than considering their assistance compensatory for perceived disadvantages associated with locating in redevelopment areas. Our review showed that EDA operating procedures do not currently provide that sufficient financial analysis be made to determine the need for EDA funding or to determine if alternative funding options are available or feasible to the loan applicant. Shortcomings in these procedures are discussed below.

INSUFFICIENT FINANCIAL ANALYSIS

While EDA has considered their loans as compensation to businesses for locating in economically disadvantaged areas, a program goal is to promote financing from alternative sources, and to minimize the use of EDA's limited loan funds. We believe that to better assure this goal is met, EDA should, in future financial evaluations, consider and analyze: (1) alternative sources of funding; (2) resources of affiliated companies; and (3) projected internal rate of return on project investment. Each of these factors is discussed below.

Alternative sources of funding

EDA's lending guidelines require an applicant to provide evidence that other financing is not available on terms and conditions which would permit completion of the project at its particular location. This evidence is to include:

> "1. Copies of letters from at least two qualified lending institutions declining to finance any part of the project or to participate in EDA's share of financing.
>
> 2. Evidence that no lending institution will participate in project financing on other than a first lien basis.
>
> 3. Evidence that other Federal financial assistance is not available to the project. For assistance to applicants in this area, EDA personnel should refer to the current catalog of Federal Domestic Assistance * * *."

These guidelines do not discuss the various alternative sources of financing normally available to large corporations for industrial expansion. We found that the companies which received EDA loans had in other instances either favorably considered or obtained financing from: internal resources, loans from affiliated companies, short term bank loans, sale of stock, bond issues, mortgages from investment companies, equipment leasing, and venture capital companies.

Resources from affiliated companies

EDA recognizes that companies which apply for loans may have principals or affiliated companies with significant financial resources, or may have adequate internal resources, projected earning capacity and cash flow, or access to other fund sources. Accordingly, to assure loan repayment, EDA views the broader economic entity, and obtains financial assurances secured by affiliated companies. Specifically the lending guidelines state with respect to guarantees that:

> "Full personal guarantees of principals of borrower and/or related corporate guarantees by closely-held corporate applicants or by the parent corporation of subsidiary corporate applicants, secured by collateral where necessary, will be ordinarily required. Likewise, cross guarantees of related corporations will be required when deemed necessary to properly support the EDA loan."

EDA's guidelines however, do not require that EDA consider these broader economic entities to determine the feasibility of alternative financing, and consequently EDA's interest is limited to the resources of the applicant company alone.

For example, in one of the cases reviewed the corporation which obtained the EDA loan was only one of ten wholly-owned subsidiary companies as shown in the chart on page 16.

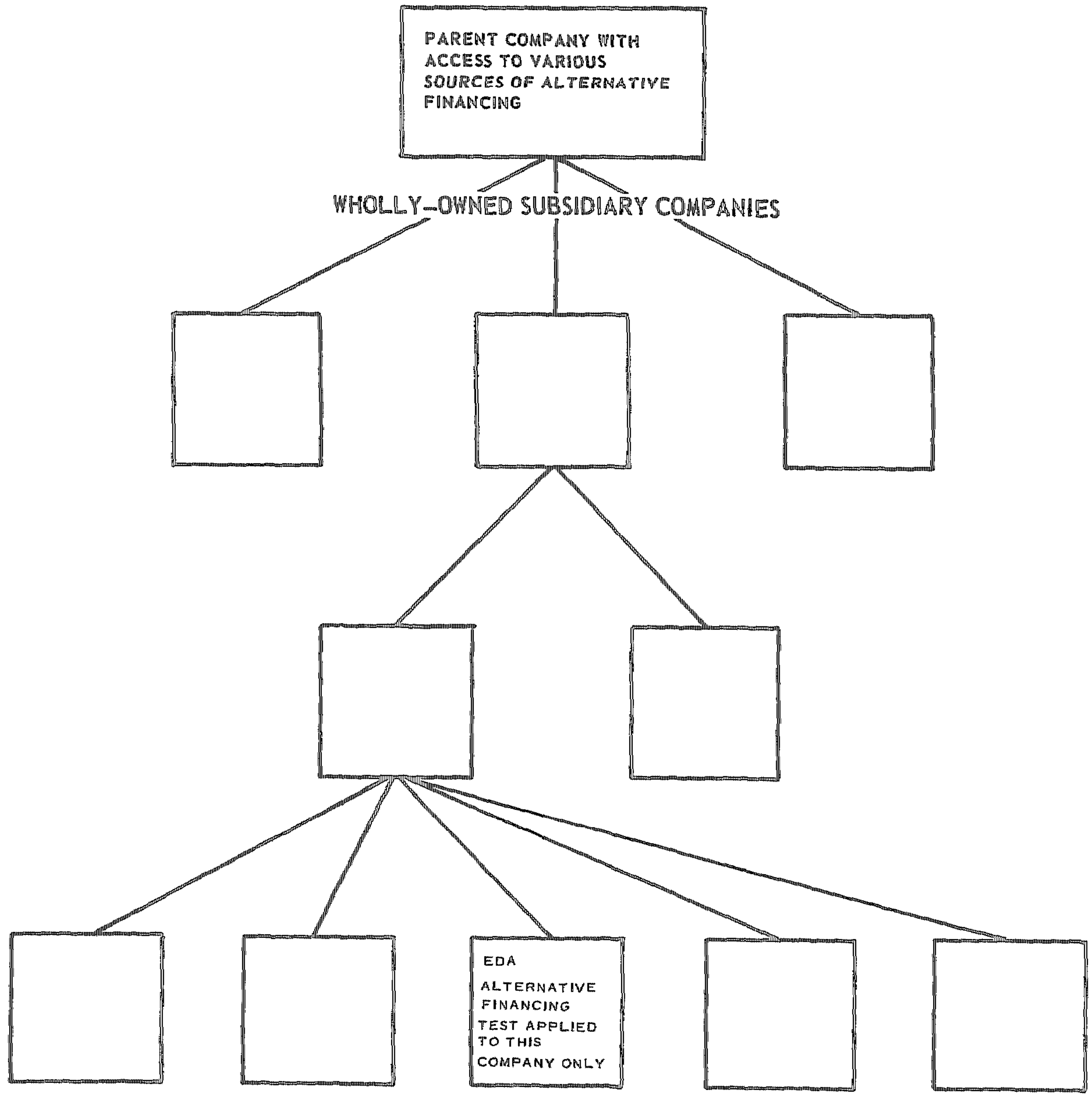
In this case, EDA, to assure adequate security for the proposed loan, considered the corporate entity and required that the parent company, with relatively substantial resources, guarantee the subsidiary company's lease payments and performance. However, EDA did not consider the parent company or affiliated companies to determine the availability or feasibility of alternative financing; EDA's files contained only two letters from banks stating their unwillingness to participate in the proposed loan.

EDA's files showed that the parent company had a consolidated net worth of about $10 million at the time of the loan application, whereas the subsidiary company had a net worth of only $57,500. Also the parent company was listed on a major stock exchange, with access to alternative capital markets including the sale of stock, bank loans, and funding generated from operations.

Projected internal
rate of return

EDA operating procedures do not provide that financial analyses be made to determine the projected internal rate of return. The internal rate of return is that interest rate that equates the present value of expected future cash flow from an investment to the cost of the investment outlay. Without EDA performing a financial analysis of the projected rate of return on the proposed project, EDA does not have, in our opinion, adequate information to establish the parameters to evaluate alternative financial resources.

An examination of two companies which received EDA loans showed that their internal resources, or their access to capital directly or through affiliated companies, were adequate to provide the required financing without EDA assistance. In one of these companies the estimated cost of the proposed project was $1.5 million, and the annual profit was estimated to be $1.1 million. According to our computation the estimated internal rate of return exceeded 65 percent. Since EDA operating procedures do


PARENT COMPANY WITH ACCESS TO VARIOUS SOURCES OF ALTERNATIVE FINANCING
WHOLLY-OWNED SUBSIDIARY COMPANIES
EDA ALTERNATIVE FINANCING TEST APPLIED TO THIS COMPANY ONLY

not require similar financial analyses, EDA did not have, in our opinion, an adequate basis for evaluating the alternative financing options.

Further clarification of internal rate of return, including its importance and applicability both for the firm requesting EDA assistance and for EDA in assessing the need for that assistance, is included in appendix I.

EDA officials agreed due to the magnitude of the problem which the agency was mandated to address and the comparatively limited level of funding, the program's overall impact has been minimal. EDA officials also agreed that businesses do consider a variety of factors in location decisions and after reflecting on our review agreed that EDA loans were not generally the primary factor influencing the businesses to locate in redevelopment areas.

EDA officials told us that they believed EDA financing allows a company to expand to a greater degree or to expand sooner than they would otherwise have been able to do. The officials stated that as a general rule they felt EDA funds were useful to businesses in financing new projects, and thereby achieved economic impact and created job opportunities.

CONCLUSIONS

EDA's Business Development Loan Program is one of a number of Federal programs directed toward economic development and the improvement of employment opportunities. The financial resources available to EDA are limited in relation to the number of depressed areas requiring assistance, the need for improved employment opportunities, and the financial resources available in commerce and industry. As a result EDA needs to be more judicious in allocating its limited funds to assure maximum effectiveness.

After reviewing the operating procedures of EDA's Business Development Loan Program, we conclude that the program needs to be reassessed to find alternative ways to more effectively meet program objectives. The policy developed by EDA of directing its Business Development Loan Program to larger companies with substantial net worth and adequate resources is understandable in light of the relative cost of administering small loans, and the greater reliability of larger companies in loan repayment and in producing employment opportunities. However these larger companies are generally likely to select locations which are advantageous based on a variety of economic and other factors, and EDA loans, or the absence thereof, are not likely to induce these larger companies to locate in areas which are disadvantageous. Furthermore, it is becoming increasingly likely that larger companies will locate without EDA financial inducement in redevelopment areas as these areas have increased in number and distribution throughout the United States.

In accordance with the intent of section 202 of the act we believe it is important that EDA reassess its program to assure that it is directed towards economic development and employment opportunities which in all likelihood would not have been created without EDA's financial assistance.

To assist in the judicious allocation of EDA's limited business loan funds, EDA needs to develop more sophisticated but accepted analytical techniques, evaluating alternative location determinations and financial options available to the applicant. In-depth financial analysis is particularly important when the businesses have adequate resources or access thereto and may not need EDA funding to assure the completion of the proposed project.

RECOMMENDATION

We recommend that the Assistant Secretary for Economic Development review and revise existing operating procedures to better assure loans are made only where there is sufficient evidence that the proposed industrial expansion is largely dependent upon EDA assistnce. Revised procedural guidelines should recognize those factors other than financing, critical in corporate location decisions, and require a more comprehensive financial analysis to assess the need of a prospective loan recipient. The financial analysis should consider those factors discussed in this chapter.

INTERNAL RATE OF RETURN

Internal rate of return was defined on page 15 as that interest rate that equates the present value of expected future cash flow from an investment to the cost of the investment outlay. Clarification of this somewhat complex definition and the relevancy of internal rate of return, particularly for a financial analyst in assessing the need for an EDA loan is discussed below.

Internal rate of return is one of several accepted and practiced capital budgeting techniques. Capital budgeting involves the process of planning for the use of a firm's capital funds. The first step in the capital budgeting process is to assemble a list of proposed new business investments, together with the data necessary to appraise them. Because a business is often faced with more proposals for projects than it is able or willing to finance it must apply some procedure to evaluate and rank them. The internal rate of return is such a procedure.

The internal rate of return is normally found by trial and error. To clarify this procedure, the steps involved in its computation are presented below followed by an example.

Steps:

1. Compute the present value of the projected cash flow from a proposed investment, using an arbitrarily selected interest rate.

2. Compare the present value obtained with the investment cost.

3. If the present value is higher than the cost figure, select a higher interest rate and compute the present value of the cash flow again. Conversely if the present value is lower than the cost select a lower interest rate and repeat the process.

4. Continue the process until the present value of the cash flow from the investment is approximately equal to its costs. The interest rate that brings about the equality is defined as the internal rate of return.

Example

Assume two projects are being considered by a firm. Each requires a current investment of $20,000. The projected cash flow of each investment proposal is presented in the table below:

--------------------- CASH FLOW ---------------------

Investment proposal 1		Investment proposal 2	
Year 1	$10,000	Year 1	$ 2,000
2	8,000	2	4,000
3	6,000	3	6,000
4	2,000	4	8,000
5	-	5	10,000
6	-	6	12,000

Step 1 - Computation of the present value of projected cash flow

15 percent (interest rate)

Proposal 1

YR. 1	(0.87)*	($10,000)	=	$ 8,700
2	(0.76)	(8,000)	=	6,080
3	(0.66)	(6,000)	=	3,960
4	(0.57)	(2,000)	=	1,140
5	(0.50)	(0)	=	0
6	(0.43)	(0)	=	0
				$19,880

Proposal 2

YR. 1	(0.87)*	($ 2,000)	=	$ 1,740
2	(0.76)	(4,000)	=	3,040
3	(0.66)	(6,000)	=	3,960
4	(0.57)	(8,000)	=	4,560
5	(0.50)	(10,000)	=	5,000
6	(0.43)	(12,000)	=	5,160
				$23,460

*Figures obtained from present value table of $1.

In applying Step 2, (comparison of the present value obtained with the proposed investment cost) the present value of proposal 1 is approximately equal to its cost and in accordance with Step 4 the interest rate of 15 percent is accepted as the internal rate of return.

The present value of proposal 2 is higher than the $20,000 proposed investment cost and in accordance with Step 3 the process is repeated using a higher interest rate. The computations appear below.

Step 1 - Computation of the present value of projected cash flow

20 percent (interest rate)

Proposal 2

YR. 1	(0.83)	($ 2,000)	=	$ 1,660
2	(0.69)	($ 4,000)	=	2,760
3	(0.58)	($ 6,000)	=	3,480
4	(0.48)	($ 8,000)	=	3,840
5	(0.40)	($10,000)	=	4,000
6	(0.33)	($12,000)	=	3,960
				$19,700

In applying Step 2, the present value of proposal 2 ($19,700) is now approximately equal to its current anticipated cost ($20,000) and in accordance with Step 4 the interest rate of 20 percent is accepted as the internal rate of return.

As stated on page 1 of this appendix, internal rate of return is one of several capital budgeting techniques which provides a rationale means to evaluate and select future capital investments. The significance of the particular interest rate that equates the cost of a project with the present value of its projected cash flow is further discussed below.

Assume that a firm obtains all of its capital by borrowing from banks and that the interest cost is 10 percent. If the firm can invest this borrowed capital in a business venture which would generate cash flows yielding an internal rate of return of 10 percent, the firm would breakeven on this investment. It is this breakeven characteristic that makes internal rate of return so important for the firm in evaluating the merits of potential business ventures.

If as in the above case borrowed capital had an interest cost of 10 percent and the computed internal rate of return exceeded that cost as it did in both proposals 1 and 2 above, then an investment in both these projects would be profitable.

If the firm's capital is limited and it has to select between proposals 1 and 2 then, all other things being equal, proposal 2 should be selected as it has a 10 percent profit margin (internal rate of return of 20 percent less the cost of capital of 10 percent) while proposal 1 has a 5 percent profit margin.

Internal rate of return would assist financial analysts within EDA in assessing an applicant's need for an EDA loan. Without employing this concept or a comparable budgeting technique to a firm's projected return on its investment, the financial analyst does not, in our opinion, have sufficient information for evaluating alternative financing options which may be available to a prospective loan recipient. The act requires that no loan be made unless financial assistance is not otherwise available from private lenders or from other Federal agencies on terms which in the opinion of the Secretary of Commerce will permit accomplishment of the project. If for example a business applying for an EDA loan had a projected rate of return of 20 percent and had access to outside capital at a cost of 12 percent, the EDA financial analyst would be in a better position to pursue with the loan applicant why EDA assistance is critical to the accomplishment of the project.

Internal rate of return would also be useful to EDA in using derived profit margins to assess the probability of a project being accomplished without EDA assistance. Theoretically, EDA's financial assistance would be more critical to the project with the smallest profit margin.