BUSINESS FINANCE AS A TOOL FOR DEVELOPMENT

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with Katharine McKee

The Aspen Institute
State Policy Program

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THE ASPEN INSTITUTE

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Executive Summary

In the 1960s and '70s, state development agencies often offered subsidized financing to firms that would relocate or open facilities within the state. By the 1980s, when the wisdom of "smokestack-chasing" began to fade, the emphasis in state economic development shifted to homegrown businesses. The smart state money stayed home and began to flow to carefully targeted firms that were indigenous to the state economy. States directly funded small business start-ups, the modernization of existing firms, and other homegrown enterprises.

Now, in the early 1990s, development finance is taking on a decidedly different identity.

Best practices in state development finance today include a number of innovative financing strategies that states employ, usually in partnership with private lenders. Linked deposit programs tie the deposit of public funds in financial institutions to those institutions agreeing to invest in targeted business sectors. Loan guarantee and loan insurance programs backed by the state allow the private market to make riskier loans. Business and industrial development corporations (BIDCOs) are private development lending institutions usually created with an initial infusion of state capital. Various kinds of state revolving loan funds and state development finance corporations still allow some states to act as direct providers of capital. Other states have recognized the successful track record of private development finance institutions through supportive regulatory change, or commitment of state funds. These are but a few of the tools in use in several states that possess innovative development finance strategies.

Today's successful development finance strategies emphasize innovation; intense knowledge and use of markets; careful analysis, planning and evaluation; and, most importantly, public-private partnerships. Development finance seems to work best where it is a

logical outgrowth of a state's overall economic development program: once the state has performed the necessary assessment of economic development needs and opportunities, then it can employ a great variety of development finance tools to meet important public objectives in the process of generating new economic activity. In almost every case, the state finds that it must engage private investment institutions in a partnership to meet economic development objectives.

The state finds that it must engage private investment institutions in a partnership

This book reviews the state-of-the-art in development finance. It briefly traces the evolution of development finance from the early, subsidy-driven programs to the emerging "Third Wave" today. It outlines the opportunities and limitations of a number of approaches, paying particular attention to the special capital needs of rural areas. It then presents a very practical series of steps to create (or improve) state development finance programs. To add dimension and illustrate the practical workings of development finance, it also offers several detailed case studies of successful programs in Massachusetts, Michigan, North Carolina, Arkansas and other states. The key points made in the brief study are:

— Successful, innovative development finance programs use public funds to leverage greater amounts of private capital. The programs are driven by demand and foster greater competition among capital providers. For reasons of accountability and continued effectiveness, they rely heavily upon monitoring and evaluation. It is not simply the economic growth and investment return that must be evaluated, but also the program's impact on economic development: Does the program meet important public objectives? Is it closing capital gaps and serving formerly neglected populations? If these questions are not part of the evaluation, then the program probably provides nothing more than what conventional finance already provides.

— Capital gaps exist in all regions of the country, but may be especially acute in rural areas. Rural regions often suffer from specialized, narrowly-based economies, low population densities and lenders' historic tendency to

avoid risk. The emergency of affiliate banking in the 1980s brought both new problems and new opportunities to rural areas. While affiliate banking has led to the creation of more banks in rural areas, lending to local businesses has not necessarily improved. Centralized decision-making often discourages local investment, which historically relied on familiarity between the lender and borrower. Nevertheless, strong state development finance programs may foster greater competition among the now more numerous rural lending institutions. With the right incentives, affiliate banking could work greatly to the advantage of rural economies.

— The timing is excellent for innovative state development finance programs to flourish. Financial deregulation coupled with new banking technologies, new products and providers (such as money market and mutual funds), and legislation fostering interstate banking and the rise of rural affiliated banks create new investment and lending opportunities. Moreover, the federal government continues to relinquish control over economic development programs. States are now in the key position to create and maintain innovative programs.

— Initiating (or improving) state development finance programs involves a series of careful steps, beginning with analysis of the state's capital market, then moving through the development of objectives and targets, the design of the program and the creation of systems of monitoring and evaluation. Perhaps the most important step in creating new development finance programs is mustering political support. If performed well, "political marketing" serves the twin purposes of achieving political validation (hence security) and creating the very public-private partnerships that are so critical to innovation and success.

Technical assistance is crucial

— Technical assistance is crucial for both the supply and demand sides of the development finance equation. Business people who lack the skills to draft convincing business and financing plans often remain invisible to conventional lenders. Conversely, few loan officers are trained well enough to spot the winners among a crop of

non-traditional borrowers. The need for technical assistance is especially acute in rural areas where potentially viable small- and micro-businesses continue to fall through the capital gaps. Technical assistance helps everyone in development finance, but is all too rare. States can look to private development finance institutions for examples of effective technical assistance efforts.

With these best practices well underway in a number of states, the challenge now remains for other states to draw from this experience to create innovative and effective programs of their own. Some locales, states and regions have demonstrated effectiveness of public-private partnerships in development finance. The best work, however, is still to be done.

Chapter 1. Introduction

Why A Development Finance Policy Guide?

Several states have been involved in development finance during the past decade. Early programs tended to subsidize business location to create or save jobs. Gradually, states began to experiment with alternative financing efforts, relying less upon recruitment subsidies and more upon state or federal funds to provide development capital. Recently, people have been questioning the success of these early efforts and calling for new ideas. Market-driven programs and new roles for the states are now emerging. This book is written for state policy-makers who are just beginning to consider how development finance relates to their state's economic development **and** for those who want to reconsider existing development finance policies. The ideas offered here describe **a new way of thinking** about how development finance fits into a state's overall economic development policies.

This discussion has several purposes. First, to offer the rationale and history of development finance for those unfamiliar with it. Second, to clarify the nature of capital gaps, especially in rural areas. Third, and most important, to present the surest steps for establishing development finance programs. Finally, to review some recurrent themes in development finance programs in order to create a conceptual model useful to policy-makers.

What Is Development Finance?

Development finance means different things to different people. The definition has evolved over time. To most people, development finance implies providing capital to individuals, firms or communities in order to stimulate development in ways that support public goals

while generating new economic activity. The goal may be to increase income and employment opportunities in rural areas, to empower minorities through business ownership, to improve living conditions for low-income people, or to promote more equitable access to resources. It is in providing these public goods that development finance differs from conventional investment. Development finance also takes a longer view of capital investment, placing a higher priority on long-term change than on short-run returns. While this definition may be widely accepted today, most state programs in the past were designed to provide subsidies for firms to locate or remain in the state. The economic development objective was to create or retain jobs, rather than to fill capital gaps or support the kinds of public goals outlined above.

Development finance takes a longer view of capital investment, placing a higher priority on long-term change than on short-run returns

Development finance is also about **changing behavior**. Providing technical assistance along with capital is a common feature, as these programs often try to increase the management capacity of small business borrowers. By forging partnerships with banks and other lenders, development finance also works to change the banking culture, making development loans more acceptable to private lenders. The notion of **partnership** is key to development finance, which represents a middle ground between private lenders, for-profit financial institutions and non-profit foundations who promote development. While private lenders are unlikely to make investments that do not generate private returns, foundations are unlikely to invest unless they see measurable public benefits. Most development finance arrangements create both private and public returns, making the partnership a realistic and often necessary ingredient.

Other Terms Defined

A **capital market** includes all sources of credit, and all sources of demand for it, in a given geographic area. Capital providers may include commercial banks, savings banks, credit unions and private investors, including family and friends of local entrepreneurs. The **capital**

these sources provide may be either **debt** (money paid back over a specified time with interest), or **equity capital** (money that becomes part of a business' capital base, yielding a return tied to the profitability of the business over time). Both kinds of capital involve risk, though equity capital is usually considered to be the higher risk.

Development capital is a debt or equity investment made to meet the capital needs of a business while achieving some **economic development objective**. For example, small business loans may provide necessary credit for expansion and generate new employment, or credit may be extended to groups who have not been involved in business ventures, such as low-income women or minorities. Development capital differs from traditional credit because of its dual objectives: achieving public benefits by meeting private capital needs.

Economic development includes more than creating jobs. It implies expanded economic opportunities, particularly for low-income and minority groups, and a reduction of economic disparities between rural and urban communities.

Development finance programs increase the supply of development capital to achieve specific economic development objectives. While these objectives may vary from state to state, the development finance programs described here have a common thread: they are designed to increase the supply of capital to particular kinds of businesses, and not merely for traditional investment in housing or community infrastructure. Important changes in the U.S. financial system—notably, deregulation beginning in the 1980s, the new federalism and the savings and loan crisis—have heightened state interest in development finance. There is thus much to be learned from a discussion of "best practices" in development finance; it is important to focus on programs with a unifying theme so that we can compare programs designed to meet similar objectives.

The need for development finance rests on two premises. First, a lack of capital constrains development,

particularly for entrepreneurs and small businesses. Second, conventional lenders often fail to allocate capital to viable businesses, creating **public and private capital gaps**. Business start-ups, modernization, expansion and survival are all threatened by capital gaps.

Today's capital markets bear evidence that large, established firms suffer less from access to capital than new, small, nontraditional businesses—for example, firms producing new products or services unfamiliar to local lenders. The higher risks and costs of lending to these small borrowers often keep lenders away. Yet these small firms create most new jobs as they stimulate local economic development.

The lack of capital for viable businesses is a sign of **market imperfection**. When a business cannot get a loan or investment even when that money would earn a competitive rate of return, the market imperfection creates a **private capital gap**: private lenders are failing to recognize a viable credit need. Several factors may be at work:

1. **Incomplete information**. Will the interest and equity earnings cover the risk involved in a particular business? Information about the investment opportunity may be lacking so that private lenders cannot evaluate the risk-return tradeoff.

2. **Transaction costs**. How much will it cost to make and administer the loan or investment? Transaction costs may be high relative to other opportunities, perhaps because of the small size of the capital need or the nontraditional nature of the business.

3. **Risk aversion**. Development finance often seems to involve higher risks while offering potentially higher returns. Lenders may be more willing to place money in low-risk, low-return investments because they are unable to spread risk or diversify their portfolios.

4. **Regulation**. Rules guiding the behavior of private lenders often restrict their opportunities to meet viable

credit needs—for example, commercial banks prohibited from making equity investments. **Liquidity** may also be an issue as regulatory requirements for capital ratios increase, constraining the bank's ability to make loans.

5. **Bias.** A borrower's race, gender, income or place of residence may impede access to credit. Capital may not flow to viable ventures in remote rural communities or inner city neighborhoods because of conscious or unconscious biases.

In the presence of any of these factors, markets may fail to allocate capital **efficiently** among competitive opportunities, thus violating the market's own "rules of the game." There may be other instances, however, when the market allocates capital efficiently but not equitably. When the market fails to achieve **equity**, then a **public capital gap** may exist.

Public capital gaps occur when the private market fails to consider social as well as financial returns on investment. For instance, an investor may consider only the return on investment and ignore job creation when, from the community's perspective, the social returns accompanying new jobs may represent most of the economic development impact of private capital. When social concerns are not considered, the capital market may starve socially beneficial development. Still, development finance should not be designed as a grant program. The objective should always be a net yield of private and social returns, though yields need not be as high as those required of purely private transactions.

Development finance should not be designed as a grant program

Public capital gaps may also occur from changes in economic conditions and, more importantly, from the regulatory response to those changes. Enhanced scrutiny of New England banking markets in the wake of the regional economic downturn and lessons learned from the banking crisis in the Southwest both led to a tightening of credit. In response, the public capital gap widened, since the loss of jobs and income during economic hardship is particularly damaging.

Many argue that governments should try to heal market imperfections. Especially when private capital fails to generate jobs for target groups or to create other public benefits, the cry goes up for government to intervene by sharing risk or reducing regulatory burdens on lenders. Although government intervention in capital markets is generally accepted, the history of development finance suggests that the form of intervention has evolved with time and experience.

The Evolution of Development Finance Programs[1]

In many of the development finance programs of the early 1980s, state and federal governments provided capital directly to subsidize business location and retention, or, in some cases, to fill capital gaps. Industrial recruitment through revenue bonds was the heart of most programs. But these suffered from centralized, inflexible administration and a limited range of financing tools—primarily debt financing. States focused most of their attention on chasing a small number of large projects—the GM Saturn plant, for example—instead of assisting the much larger number of small, in-state enterprises who needed help. Typically, the programs were not focused on well-defined economic development goals.

As the decade progressed and federal involvement in economic development declined, states redoubled their efforts. The focus shifted from centralized industrial recruitment to promoting homegrown businesses and entrepreneurs. Development finance programs were now targeted at particular capital problems, such as inadequate assistance in small business start-ups or modernization of viable industries. Recognizing that there are appropriate forms of capital for each business stage, development financiers began to explore ways to increase both equity and debt capital. New sophistication called for professional management; the general administrators of the early programs were not up to the tasks of meeting the new, refined objectives.

Still, state development finance programs were severely limited; their scale and impact remained small. Coordination among programs was lacking so that small businesses were unable to obtain a needed package of services—for instance, technical assistance or job training along with capital. Managers recognized the need to get banks and other private partners involved, but lenders' fears of liability kept them from providing both technical assistance and credit. Since states were providing capital directly, they were immune to normal market competition; nor were they pressured to perform as efficiently and equitably as possible. Rarely were explicit evaluation mechanisms built into the programs.

Development finance programs came to focus on in-state businesses

Nevertheless, development finance programs gradually improved as they came to focus on in-state businesses as the cornerstone of states' economies. The evolution of these programs followed the changes many states made in their overall approach to economic development. The limited returns from industrial recruitment coupled with the internationalization of the U.S. economy led to alternative approaches attuned to the needs of emerging businesses. New attempts to redefine goals and create tools for implementing state economic development programs may be called the "Third Wave" approach.[2]

The Third Wave

The "Third Wave" in state economic development maintains the focus on homegrown businesses but suggests new ways to stimulate business. A set of guiding principles suggests that these programs should have the following features:

1. **Demand driven**. Does the program address the real capital needs of businesses? Firms targeted by the program must be willing to put their own resources at risk in a partnership. The businessperson must view the program as worthwhile enough to risk money, materials and personnel in it.

2. **Leverage resources.** Does the program use limited public funds to draw in significant resources from the private sector? This serves to tap private expertise while ensuring that the scale of the program is sufficient to meet economic development needs.

3. **Competition encouraged.** Does the program encourage the creation or expansion of private institutions to provide capital and services? Public programs must relinquish their position as the sole supplier of services and encourage private sector competition to increase efficiency.

4. **Automatic feedback.** Is there a way to evaluate programs and make appropriate adjustments? Programs must be responsive to client groups and the public. Program design must include ways to evaluate and monitor progress.

5. **Market orientation.** Does the program strengthen existing markets or create new ones? A competitive capital market would have many of the characteristics above. The state may be able to meet development objectives by modifying existing markets and capturing their efficiency. But in some cases the markets may not exist, and the state must create them. The challenge here is to encourage competition among capital suppliers.

In applying the "Third Wave" approach to development finance, states face many options for closing private and public capital gaps. As a first resort, states should try to correct market imperfections so that capital flows to viable small businesses. The state may use its regulatory authority, promote technical assistance to banks and small businesses, or create incentives for greater private lending. These actions may close private capital gaps and strengthen private markets rather than replacing them with public finance.

As a second option—especially where the goal is to increase opportunities in distressed areas—states may need to become investors working in partnership with financial intermediaries. The state can play an active role

by creating new lending institutions, or it can be more passive by supporting existing development financiers. In either case, the principle of leverage is key: states can use public investments to stimulate additional private finance for projects with well-defined social benefits.

Finally, there remains a role for the state as direct provider of investments in projects with clear public benefits but no private support. The state role as direct provider should be viewed as limited, however—to be filled only when private options are exhausted.

Chapter 2. Needs and Opportunities

Development Finance for Rural Areas

While most development finance issues are identical in both urban and rural areas, rural economic development problems and credit needs differ. Most rural communities are small and remote with low population densities. They have specialized economies, often tied to agriculture, and a more limited public infrastructure and service base. They often suffer from outdated telecommunications, limited educational facilities and fewer financial institutions. While these conditions may depress rural economic development in general, they are especially severe for the start-up and growth of small businesses. Moreover, rural areas in the United States still suffer from the 1980s decline in agriculture and energy-based industries. Traditionally low-skill, low-wage manufacturing industries face increasing competition from other countries. All of these problems suggest the need for innovation that recognizes the differences between rural and urban economic development.

Conditions are especially severe for the start-up and growth of small businesses

The structure of rural banking markets also changed with deregulation in the 1980s. While many of these changes led to expanded choices for rural firms, rural capital markets still have less competition and less sophisticated services than urban markets. The number of banks operating in rural markets may have increased during the 1980s, but rural firms still have fewer options than their urban counterparts. Thirty percent of rural banking markets are still served by only one or two banks, suggesting that those lenders have greater market power than their small business borrowers. Rural banks are also less likely to employ experienced commercial lenders.[3] A small business person whose loan is rejected must either go to an inexperienced local lender or look outside the local market, at increased cost. In either case, the result is likely to be reduced access to credit.

The Extent of Capital Gaps

Research on capital availability at the state and local levels has identified market imperfections and access problems for certain classes of business. Market imperfections range from racism in lending patterns to increased information and transaction costs associated with small business and rural lending. These costs are expected to increase as deregulation and remedies for bank failures lead to greater consolidation in the banking industry. In spite of regulations against **redlining**, when commercial banks deliberately restrict lending in certain low-income, minority neighborhoods, recent studies have found that racial disparities in lending continue in many urban markets.[4] These practices create capital gaps for minority individuals and communities, thus reducing their economic development potential.

As deregulation continues, differences between small banks and affiliates of larger institutions take on greater significance

As financial deregulation continues, differences in lending between small independent banks and affiliates of larger institutions take on greater significance. There is evidence that affiliated banks have greater access to capital through the holding company structure and may increase fund availability, particularly in rural markets. At the same time, loan decision-making for large banks operating in distant markets—for example, urban-based banks operating rural branches—is increasingly centralized and local autonomy is reduced. Since information and transaction costs increase with distance, loan decisions are often made on the basis of financial formulas rather than character judgment. This works against small businesses. Larger affiliate banks appear to target their services to the needs of larger, more sophisticated businesses; moreover, local economic conditions play a more important role in the lending policy of large banks. The ease with which funds can be moved among subsidiaries in response to economic conditions makes large banks more likely to shift money away from communities in economic decline, suggesting greater credit access problems for small businesses.[5]

Independent banks also face constraints that limit their ability to capitalize small businesses. Independents tend to be more risk-averse, placing a larger percentage of their assets in safe government securities than into riskier loans.[6] Thus, a smaller percentage of local deposits are returned to the community through loans.[7] While independent banks in New England make most of their loans to relatively small businesses, they are more likely than affiliated banks to reject small business loan applications from new firms with no track record.[8] This bias against start-up lending may result from inadequate capacity to evaluate risk.

An important policy and research task is to evaluate rural capital gaps. While some believe that the centralization of finance has harmed once-isolated rural markets, research shows that the increased presence of affiliated banks has not resulted in an outflow of funds. Rather, there seems to be a reallocation of capital between rural areas, with funds flowing from more slowly to more rapidly growing rural communities.[9] This result is consistent with affiliated banks placing greater emphasis on local economic conditions in making loans. It does not bode well for small rural businesses during an economic downturn.

There seems to be a reallocation of capital between rural areas, with funds flowing from more slowly to more rapidly growing rural communities

More recent studies of deregulated rural capital markets have found no evidence of complete market failure, at least in regions experiencing growth. Still, there are concerns about capital access for particular classes of firms. Small and start-up firms face greater problems, as do those in emerging or nontraditional industries. Acquiring long-term and unsecured debt and equity capital is more difficult for small rural businesses, particularly those relying on nontraditional collateral.[10] These results suggest that high transaction or information costs coupled with the higher inherent risk in small business lending may create credit gaps. These problems may be exacerbated further by declining economic conditions or bankers' desires to shift toward new investments, such as securities. Underlying all of these changes is the inherent instability and risk involved as firms learn a new market.

An entrepreneur may lack the expertise to formulate a bankable deal

Capital gaps may result from an **insufficient supply** of capital to viable enterprises; much of the research discussed above has addressed these gaps. However, they may also result from a **lack of effective demand** for credit. An entrepreneur may identify a need for credit but lack the technical or management expertise to formulate a bankable deal. While there is demand in this case, it is not effective demand. To eliminate this kind of gap requires technical and business assistance for new enterprises before more capital can be well used. On the other hand, bankers' limited capacity to evaluate risk may create the impression that effective demand is lacking. Small or rural bankers in particular may not recognize viable small business deals because of limited training and experience. Technical assistance for bankers may be required to close this credit gap. A truly effective development finance program recognizes that capital gaps may result from deficiencies on either the demand or supply side of the capital market. The program must be designed to address them accordingly.

The studies described above provide insights into credit needs based on analysis of available data, which in many cases limits the questions addressed and the conclusions drawn. However, development practitioners operate under some generally accepted conclusions about capital gaps, particularly in rural areas. These are based on working in the field with small business borrowers and lenders; many of these conclusions are supported by available academic research. From practitioners' experience, greater capital access problems exist for new, small or expanding businesses, those owned by minorities and women, and those in the middle-risk market (defined as standing between low-risk, low-return bank financing and high-risk, high-return venture capital investments). Particular types of capital are also scarce: long-term, fixed-rate loans; venture capital (especially in rural areas); credit for product and process development; and, seed capital for small firms. Moreover, many bankers do not aggressively pursue small business loans, as evidenced by failure to employ Small Business Administration and state financing programs and limited

knowledge of alternative lenders who could help package small business deals.

For policy-makers, these findings combined with the experience of development practitioners create a powerful argument in favor of public sector involvement. The kind of research outlined above can be used in considering the appropriate public sector role to meet economic development objectives in each state.

Is This the Right Time for a State Development Finance Program?

Initiating a development finance program today may seem like a poor idea, given general economic uncertainty coupled with changing and, in some cases, unstable financial markets. However, several factors make this a prime time. First, deregulation of the financial industry led to fundamental changes in the way services are provided. New technologies (automatic teller machines, for example), products (money market accounts), providers (mutual funds), and legislation (interstate banking) have revolutionized the industry. Much bank management strategy over the past decade has been in response to these important changes. The rise of rural affiliated banks during the 1980s has increased the competitive pressure on previously insulated independents.[11] Most rural bankers have had to adapt in order to survive.

Several factors make this a prime time to initiate a development finance program

Second, the federal government is relinquishing control over economic development programs. Rural development provisions in the 1990 Farm Bill call for the establishment of a five-state pilot program to provide seed capital for local revolving loan funds. States would be eligible to administer them, tapping a potential source of federal monies that can be used to leverage private resources. Funding for this legislation is not yet assured, but it shows the new direction of federal programs. States are taking control of economic development; their tendencies toward innovation must continue if they are to meet increasing demands with dwindling public resources.

Third, the crises in the savings and loan and banking industries create new problems and opportunities. The problems may arise from regulators' hesitancy to make changes that enhance risk-taking among financial institutions. Indeed, regulators may feel pressure to enforce existing regulations more stringently, taking flexibility in loan packaging away from local bankers. These changes may result in reduced credit for small businesses. On the other hand, proposed banking reforms create a new opportunity for policymakers concerned with development finance. Financial modernization—for example, expansion of banking powers to include involvement in securities, mutual funds, and insurance—creates an opportunity to link expanded powers with requirements for disclosure of development lending activities. In addition, national interstate banking could allow states to require bank holding companies to submit plans for development lending. These reporting requirements are already being used in some states.

Tough times breed tolerance for alternative ideas

Finally, tough times breed tolerance for alternative ideas and innovative solutions. In troubled economic climates, credit needs are likely to increase, particularly for small businesses, but strictly private options for meeting those needs may be limited. The demand for innovative public solutions, including public-private partnerships, is great. New signs of innovation are already on the horizon. The state of New Hampshire and the Federal Deposit Insurance Corporation (FDIC) recently proposed a plan to encourage weakened state banks to find well-capitalized merger partners. The FDIC would then consider putting additional public capital into the merged institution. While the impact on the availability of development capital may be limited—the plan does not explicitly require development lending—the objective is to create credit in a state faced with recession. Such leadership in these critical times may be the key to addressing the development credit needs in most states.

Chapter 3. Establishing a State Development Finance Program

Establishing a State Development Finance Program

Establishing a development finance program involves a number of important steps. Even those from states with existing development finance programs may find the following useful as a way of taking stock of ongoing activities. Development finance programs are not static. They should change as economic conditions or economic development objectives in the state change. Since many programs are young and experimental, they may need to be fine-tuned with the knowledge gained through experience. In many cases, programs were established with industrial recruitment, not development finance, in mind. Now it may be time to make the development objectives of these programs more explicit by tying them directly to state economic development and emphasizing the partnerships that are inherent in these activities. In any case, the steps outlined below provide a framework for thinking about development finance programs. They should be useful to both experienced and novice state policy-makers.

Step #1: Analyzing the State's Capital Market

The analysis of state capital markets must focus on the institutions that **supply** capital—commercial banks, savings banks, credit unions—as well as the businesses that **demand** it. On the demand side, the analysis must look not only at businesses and their credit needs, but also at the organizations providing technical and management assistance as a way of increasing the demand among credit-worthy enterprises. Analyzing state capital markets is a murky process. In many states it may not be possible to identify and address a well-defined, quantifiable capital

gap. Nevertheless, gathering the best information available remains a key to gaining consensus for appropriate development finance programs at a later stage.

From a policy perspective, there are two ways to conduct the type of analysis recommended here. The first approach—a broad **capital market audit**—is comprehensive. It seeks to identify the type of capital available from existing institutions in the state; the need for capital by businesses in different stages of development, different industrial sectors, and different settings (e.g., rural or urban); and the fit between supply and demand. This capital flow study will identify the patterns of capital availability and sectors facing access problems. An in-depth audit requires a significant commitment of state resources since the data must be collected through surveys of financial institutions, borrowers and prospective borrowers. It may be necessary to seek outside consulting assistance from an organization familiar with the methodology.[12]

The second approach is more targeted. It may identify a specific public policy goal—for instance, promoting self-employment for low-income individuals—and conduct a study to evaluate the credit needs of this particular group. Such a focus will lead to consideration of the particular policies and programs required to fill capital gaps for the target population. While the statewide impact may be small in terms of jobs, tax revenues, and economic growth, the credibility gained from addressing a targeted credit issue may build a constituency to support broader development finance initiatives.

Development finance is just one piece of the state's overall initiative to stimulate economic development

Regardless of the approach, several principles must guide the assessment process:

1. An analysis of state capital markets must fit into a broader analysis of economic development conditions, problems, and opportunities in the state. Development finance is just one piece of the state's overall initiative to stimulate economic development. Capital needs and availabilities must be evaluated within this context. For example, if the state places a high priority on the need to

improve economic opportunities in **depressed rural communities**, then the analysis of state capital markets should be designed to assess the nature of **rural capital gaps**. Addressing these through a development finance program may increase the potential for rural economic development.

2. Information gathered during the assessment is an essential input to the **consensus-building process**. The assessment may demonstrate the need for public intervention to make private capital markets work better. Identifying and documenting specific capital gaps will provide the justification for choosing particular development finance programs and targeting certain groups, types of businesses, or geographic areas for investment. For example, in western North Carolina, the Center for the Improvement of Mountain Living was able to demonstrate the potential demand for small business loans by working with local banks to track loan applications and the reasons for rejection. This information was useful in convincing bankers of small business demand and initiating discussions on appropriate interventions.

Capital markets are fluid

3. Capital markets are fluid and can be expected to change over time, sometimes dramatically. Any market study must recognize the underlying economic conditions and understand how they affect credit availability. As mentioned earlier, a study of credit markets in New England prior to today's economic downturn found some very specific credit gaps. A development finance program based on that analysis would have been targeted very narrowly. However, circumstances just two years later suggest that problems within the banking industry have led to tighter credit and a larger range of businesses facing credit problems. The capital needs addressed by a program based on present conditions would likely be less targeted and more flexible. To keep programs flexible and market-driven, states may want to establish public forums for communicating changes in private markets so that policy can be responsive to changing economic realities.

4. Private financial institutions should be brought into the assessment process from the beginning. Their

Cost vs. Availability of Capital

The most effective development finance programs focus on increasing capital **availability** rather than subsidizing the **cost** of capital to borrowers. In cases where below-market rates of interest are charged to small borrowers, the overall impact on a firm's operating costs is limited. To illustrate the point, take a small manufacturing firm with annual gross sales of $637,000. The firm is seeking a loan of $20,000. The firm's total costs are $522,574 and current interest expense, before the additional loan, is $33,353. Interest expense accounts for 6.4 percent of the total costs.

Consider two different loan scenarios. In the first case, the business obtains the $20,000 loan for seven years at a five percent rate of interest: **below-market rates**. In this instance, the total interest expense over the life of the loan will be $7,000 or $1,000 annually. This additional expense represents an increase in the firm's total interest costs of about three percent or an increase in total costs of 0.2 percent.

In the second case, the firm qualifies for a **market rate loan**, getting a $20,000 loan for seven years at 12 percent interest. In this case, the firm's total interest expense will increase to $16,800 or $2,400 annually. However, even with the higher rate of interest, the firm's total interest costs increase by only 7 percent while total costs increase by only 0.4 percent. Compared to other expenses incurred by the firm, these additional interest costs are relatively small. For example, total labor costs represent 29 percent of the firm's total costs, while taxes and insurance represent 7 percent. The below-market interest rate represents a cost savings to this small firm of $1,400, or only 0.3 percent of total costs. At the same time, the below-market rate does not reflect accurately the true costs of borrowing, given the higher risk and transaction costs involved for this small firm.

Development finance programs should be designed to enhance capital availability, not just subsidize capital costs. Cheap credit programs often

serve firms that could get loans from other sources, but at higher interest rates. Charging market or above-market rates of interest allocates scarce capital resources to small firms that are willing and able to pay higher interest rates in order to gain access to capital. By pricing development loans to reflect the cost of capital to smaller, riskier enterprises, financial institutions, whether traditional banks or development finance organizations, are more likely to cover the true costs of lending to small businesses, including the technical assistance required, and make small business lending sustainable in the long run.

cooperation is essential in order to obtain accurate data on capital availability. Since banks are required under the federal Community Reinvestment Act (CRA) to assess **community credit needs**, one may be able to strike a deal, exchanging information gathered from a capital market audit for more detailed information on bank loan portfolios and lending policies.

Foreign assistance programs have taught us that simply transferring technology from one area to another is not always an effective way to stimulate economic development. Similarly, development finance programs cannot be borrowed from another setting with any guarantee of success. Evaluating local capital markets is an essential first step in designing programs to meet the capital and economic development needs in each state.

Step #2: Establishing Program Objectives and Targets

The second step is to determine the program's objectives and targets. Does the state need a general development finance program, providing a range of capital to businesses statewide, or are there persistent credit needs that must be met through a more targeted approach, focusing on one type of credit or business? To address these questions, one must rely on the capital

market assessment and an understanding of the political climate of the state. For states with a dominant economic sector, such as agriculture or traditional manufacturing, the target may be relatively clear. In other cases, a change in the dominant economic sector may signal the need to focus development finance on an emerging sector, such as high technology industries in Massachusetts, California, and North Carolina in the 1980s.

Development finance objectives will flow out of the broader economic development objectives

Ideally, development finance objectives will flow out of the broader economic development objectives set by state policy-makers. For example, one broad objective may be to improve the income and job opportunities for low-income residents. A related development finance objective would be to increase the supply of credit and technical assistance for low-income people interested in self-employment. Establishing program objectives should come after considering the capital needs in the state, so that existing capital gaps are addressed. However, since one great advantage of these programs is their ability to achieve economic development objectives, it is essential that specific objectives be established from the beginning.

The answer to the targeting question will follow once again from the assessment of capital needs. It is possible that local businesses face a wide array of capital shortages, from inadequate equity or start-up capital to insufficient long-term debt. An appropriate development finance program may be to increase the supply of various capital instruments to a broad group of businesses throughout the state. On the other hand, if credit markets work well for most businesses, but very specific credit gaps exist, a highly targeted program may be most efficient. Since state funds are limited, it is important that they be applied to achieve **maximum public benefit**. Development finance programs will have greater impact the better they are targeted to key industrial sectors, regions, or types of businesses that have growth potential. Alternatively, programs may be targeted to achieve other public goals, such as the elimination of racial or gender discrimination in credit markets.

Can generic programs address rural needs?

The issue of targeting is particularly vital when considering rural vs. urban capital gaps. An important policy question is whether rural development finance programs are needed or whether more generic programs can address specific rural needs. The answer will be based on the nature and severity of rural credit gaps and the political clout of the rural constituency in a particular state. Political support for rural development finance programs may be lacking in some states, so a generic program with monies targeted to rural areas would likely be more acceptable. However, when rural credit needs are acute, there is the danger that program funds will be diluted in a broader state program.

Step #3: Determining Key Program Design Features

Development finance programs should include the four generic features presented below. Designers may add other parameters as dictated by their own professional or political experience and the unique circumstances in their state or community.

1. Programs should be **market-driven**, meaning that services are provided in response to demand. In addition, programs must be flexible so that services can change with market conditions. For example, Illinois' small business loan program was adapted over time to meet the credit needs, first of microenterprises, and later of female- and minority-owned businesses. The number of loans made through the Illinois program can vary as economic conditions warrant.

2. Given that capital gaps may arise from either supply- or demand-side weaknesses, **technical assistance** to both bankers and businesses is an essential component of most programs. Businesses must have access to management assistance so that capital is used most effectively. At the same time, bankers, particularly in small rural banks, may need information and assistance in order to address the credit needs of particular groups in the market—for example, firms requiring equity as well as debt financing.

The technical assistance component of these programs needs to be market-driven as well, provided by competitive organizations responding to the needs of the business and banking sectors in the community. If they are providing a valuable service, clients will be willing to pay for it and make some effort to obtain it.

3. Programs must be run by **professional, entrepreneurial managers** who can respond to changing credit needs and economic conditions. While development finance programs have a broader set of goals than traditional financial institutions concerned with rate of return, safety and soundness, the ultimate success of the program depends upon the people who run it. Managers must maintain the financial integrity and guide the program toward self-sufficiency—the point where operating expenses and continued investment can be covered by program income. At the same time, the program must be accountable for achieving its public policy objectives. If the state's role in development finance is regulation, the creation of incentives, or investment in existing institutions, programs may be run effectively as part of existing bureaucracies. However, if the state is involved in creating new institutions or providing direct financing, the most effective models appear to be separate entities guided by economic development goals—either private, non-profit organizations or quasi-public entities with their own independent boards.

The most effective models may be private, non-profit organizations or quasi-public entities

4. To ensure accountability, **systems for evaluation and monitoring** must be built into each program. The ability to evaluate programs is linked directly to the degree of professional management; the evaluation in turn provides information to help management respond to changing circumstances. Since development finance evolves constantly, it is important to evaluate the effectiveness of alternatives and make appropriate modifications. However, it is difficult to evaluate a program without first identifying which criteria are important to measure and gathering the necessary data. In development finance, it is not enough merely to evaluate

financial health such as the rate of return, loan delinquency and capital reserves. One must also measure the developmental impact of loans and investments. How many jobs were created? How many people became self-employed? How much additional investment was leveraged? The answers to these questions provide the basis for evaluating each program as a **development program**, not merely as a **finance program**. The relevant information for such an evaluation must be identified at the outset, based on the objectives of the program, and a mechanism for collecting information and monitoring performance over time must be established.

Step #4: Evaluating Best Practices

States must be willing to share successes and failures with others. What makes the most **innovative** programs work? A set of models is presented here, each one capturing the state in a particular role—the state as regulator or inducer, as investor, and as direct provider of capital. There are other ways to categorize state development programs, but these models define alternative roles the state may assume in development finance programs. The choice of approach will affect the program's cost, ease of administration, and complexity.

The models demonstrate varying degrees of state involvement. At one end of the spectrum, the state plays a catalytic or regulator role. For example, it may pass reinvestment legislation tying the deposit of state funds to a bank's provision of capital to small businesses in low-income communities. In this role, the state works within the private market to change the rules of the game and induce private sector investment that meets economic development objectives. When this proves insufficient to promote economic development, the next step is for the state to assume the role of investor, usually working in partnership with private institutions or, if needed, creating new ones. For example, the state could make an investment in an existing development credit union that was providing financing to small rural businesses. Finally,

as lender of last resort the state may provide needed capital when the return is too low and the risks too high for private investors. Broader public benefits may be great enough to justify direct investment by the state. One example is a state program to provide equity capital to traditional manufacturing firms that are not expected to generate the high returns required by venture capitalists.

The programs discussed below represent **best practices** in development finance. But no single model will work best in all states. These programs reflect the latest thinking and innovation in development finance. In some cases, the program is unique to one state; in others, it has been replicated widely. In all cases, the programs are attempts by states to address the capital gaps that limit economic development.

Chapter 4. The Role of the State in Development Finance

The State as Regulator or Inducer

The public sector has the unique capacity to catalyze change among private institutions. Most mechanisms the state can use to instigate changes fall into two categories: **carrots and sticks.** The state can offer **inducements** to private sector institutions to encourage particular types of development lending—to minority businesses, for example. Alternatively, the state may wield the stick to **regulate** lenders to achieve the same ends. In development finance, the use of each mechanism has led to innovative programs.

Linked deposit programs, a popular way to encourage development lending, tie the deposit of public funds in an institution to its policy of lending to meet critical capital needs, such as low-income or small business lending. A state invests part of its regular portfolio in a bank at below-market interest rates. The bank, in turn, agrees to lend the money at below-market rates to qualified small business borrowers. But these programs often do not work well as development stimulators. Since in most cases the small business borrower already qualifies for a market-rate loan, the linked deposit program simply results in an interest subsidy. Moreover, the state sacrifices revenues on its deposits, anticipating that the public benefits—increased tax revenues and employment from business expansion—will compensate for the loss. The results show mixed performance depending on the types of loans made and the targeting of the program. One study of six state-linked deposit programs found that the states, on average, lost about $4,000 per loan. Since the programs were not targeted explicitly to groups with capital access problems, the economic development benefits were nebulous.[13]

Massachusetts takes a much more innovative approach to linked deposits: the investment of public funds is linked to community lending performance and Community Reinvestment Act evaluations. Any in-state bank or thrift can bid for public deposits and, as a condition of the award, it is required to allocate 70 percent to specified kinds of loans, such as small business loans, mortgages and home improvement loans in low-income communities or neighborhoods. These categories correspond to perceived capital gaps among target populations. Continued eligibility in the program is based on the bank's performance in increased lending to the targets. Consequently, Massachusetts' linked deposit program has a developmental impact; it does not merely subsidize the costs of capital for bankable businesses.

Massachusetts' program does not merely subsidize the costs of capital

It also creates competition for public deposits and rewards banks for contributing to the supply of development capital. Private institutions are encouraged to increase their development lending through judicious investment of public deposits. The cost to the public is the loss of interest on linked deposits, but it involves no **additional appropriation** of money. To the extent that these linked deposits stimulate further lending in the long run, the public benefits may be high. But even this program has an important drawback. Linked deposits depend upon the availability of state funds for six- or twelve-month investments. With the state in financial crisis, the availability of public funds is severely limited.

In 1988, a boom year, the Massachusetts treasurer placed $90 million in the linked deposit program. But for the past two years, there has been no money available. The result is an inconsistent supply of loanable funds at the very time when demand for funds is likely to be high. Given the program's limited history, it is also difficult to evaluate whether the lending performance criteria are being met. If public deposits are not used to reward banks that increase their lending to the targets, then this program has no major advantages.

To help capitalize businesses which lenders view as higher-risk, states use another popular tool: **the loan**

guarantee program. The businesses receiving guaranteed loans generally fall between the low-risk, low-return enterprises traditionally served by banks and the high-risk, high-return firms sought by venture capitalists. With the guarantee, the lender and the state share the risk that the enterprise will fail. The state appropriates money that can be used to secure a certain portion of commercial bank loans. California's program, for example, guarantees that the state will repay up to 90 percent of the loan in case of failure. Loans are initiated by the small business borrower who approaches the bank directly. The bank decides whether or not to proceed with the loan, subject to obtaining a state guarantee. Still at risk for a small percent of the loan, the bank has an incentive to make a sound decision. The guarantee should increase credit availability for higher-risk enterprises that might otherwise be turned away.

The state must be able to evaluate the potential success of ventures it guarantees

To be successful in the long run, the state must be able to evaluate the potential success of ventures it guarantees so that funds are not depleted and additional money is available to support the program. The future of loan guarantees would be threatened by high loss rates. Once again, the California Loan Guarantee Program offers a sound approach. It authorizes guarantees through regional non-profit intermediaries known as Small Business Development Corporations (SBDCs). These offer technical and management assistance to small businesses; the SBDCs have access to better information about local lending prospects and are better positioned to evaluate the risk-return tradeoffs inherent in each loan guarantee.

Loan guarantees can increase commercial capital to projects that would not have been undertaken otherwise, but the guarantee shifts much of the burden for loan evaluation to the public sector since banks are protected against losses from poor loan decisions. In this sense, loan guarantees do not take full advantage of bankers' expertise and indeed may encourage banks to pursue guarantees for loans with limited potential for both returns and developmental impact.

An alternative tool that addresses this issue is a **risk pooling or loan insurance program**. These typically

require payment of a one-time fee or loan premium, equal to a percent of the total loan value, by the borrower and the bank. The premium is matched by a state contribution. These combined funds form a loan loss reserve the bank may use against a portfolio of loans made under the program. Since the loss reserve covers only a portion of the loan amount, there is a strong incentive for the bank to accurately appraise the risk of each loan and place only moderately-risky loans into the program. Since the borrower, bank, and state are partners in the risk pool, the bank is encouraged to accept loans with more risk than those in the rest of its portfolio.

The Michigan Capital Access Program (CAP) provides a successful model of a risk pooling program (see box beginning on page 31). It increases capital availability to businesses that are perceived as being too risky for conventional lending, yet the responsibility for making and monitoring loans resides with private institutions, not the state. In keeping with the principles of innovative development finance programs, CAP is demand- and market-driven; it enhances private investment rather than replacing it with a state program, and provides banks with the flexibility to meet changing capital needs in their markets.

The Massachusetts Capital Resource Company (MCRC) offers a different approach to increasing private development lending. MCRC was created in 1978, the result of a deal struck between the governor and the state's life insurance industry. The insurance industry sought repeal of a one percent tax on gross income, while the governor wanted insurance industry investment in high technology. In exchange for the tax cut, the industry agreed to create the $100 million MCRC which would make unsecured loans or investments in businesses that could not get funding from other sources. The legislation specified criteria for these investments—firm size, location, and ownership—and made the tax cut contingent on meeting certain investment and job creation targets.[14]

Several factors contribute to MCRC's success. First, the investment record has been very good. Between 1978 and 1989, MCRC invested over $223 million in 150

Michigan's Capital Access Program

The Michigan Strategic Fund's Capital Access Program (CAP) provides "a non-bureaucratic, flexible tool for banks to make loans that are somewhat riskier than a conventional bank loan."[15] CAP expands the capacity of the private sector to make riskier small business loans while allowing banks to maintain control over loan decision-making. The bank decides whether to participate in the program, what loans to make, and on what terms. The program promotes a simple way for banks to expand their customer base and to meet the credit needs of small businesses.

CAP works on a risk-pooling or portfolio insurance concept. When a bank participates in CAP, a special reserve fund, owned and controlled by the Michigan Strategic Fund (MSF), is set up in the bank's name. This reserve is used to cover losses on loans made under the program. The reserve is funded by a one-time borrower, bank, and MSF contribution when a loan is booked. The borrower and bank pay a combined fee (between 3 and 7 percent of the loan value), which is matched by MSF. For each loan, 6 to 14 percent of the loan value is contributed to the reserve and made available to cover losses. The reserve can cover losses much greater than the typical one-percent losses tolerated on traditional commercial loans.

CAP has a number of self-regulating market mechanisms that protect against abuses. Since each bank is at risk for losses greater than those covered by the reserve, loan officers are encouraged to be prudent in their decision-making. In addition, loans made under the program are more expensive than conventional financing, so only those businesses unable to obtain financing are likely to opt for a CAP loan. CAP, however, can turn many small businesses from unbankable to bankable, at least under the program's innovative conditions.

In operation since 1986, CAP has several years of lending experience that can be evaluated to see how well the program is achieving its objective:

enhancing capital availability for small businesses by increasing banks' abilities to take risks. At the end of 1990, 87 banks, controlling about 85 percent of the state's commercial bank assets, had signed onto the program, with 50 banks actually making CAP loans. From 1986-1990, 894 Michigan firms had received CAP loans; 382 new loans were made in 1990. The loans totalled $46.4 million, leveraging $2.4 million in MSF deposits into the reserve by a ratio of 23:1. These figures represent substantial growth since CAP's inception.

Bank participation and loan growth have been substantial, but are these loans going to the small businesses targeted by CAP? The data suggest that they are. The average loan made under CAP is $52,000, with two-thirds of the loans under $50,000 and 10 percent under $10,000. Of the firms receiving them, 90 percent have annual sales of less than $1 million, 60 percent sell less than $200,000, and 20 percent are start-up firms. These numbers prove CAP's effectiveness in expanding credit to small businesses and start-up firms—the very firms that are typically starved for capital.[16]

When CAP was established, some expressed concern that the program would be less attractive to small- or medium-sized and rural banks. These banks, some feared, may be less likely to develop a loan portfolio sufficient to take advantage of the program. However, the experience to date shows that small banks are over-represented and rural banks have participated in rough proportion to their numbers throughout the state. In fact, the under-representation of larger banks suggests that the greater decision-making flexibility in smaller institutions may facilitate adoption of this innovative program.

Redundancy was another early concern: would CAP actually stimulate new commercial lending or would many of these loans have been made without the program? During interviews conducted for an evaluation of CAP, bankers indicated that 70 to 75 percent of their CAP loans **would not have been made otherwise**. Small business people said that until CAP came along, they had been **unable to get financing** either because of the types of loans they needed or their stage of business development.

Information on the costs of CAP loans suggests how crucial they have been in rescuing a starved segment of the borrowers' market. Interest rates charged on CAP loans averaged two points above prime, and borrowers were required to pay a one-time fee, averaging about 3.8 percent of the loan value, since most banks passed their reserve contribution onto the borrowers. CAP loans are not cheap. They offer a weak incentive to businesses able to qualify for conventional financing. The large number of loans made at these higher rates supports an inevitable conclusion: it is **access to capital, not its cost**, that constrains most small businesses.

One other measure: If CAP is achieving its objective, loan loss rates should be higher than those experienced by commercial banks on conventional loans. Otherwise, CAP would be substituting for the private sector rather than augmenting it. Actual loan loss rates on CAP loans appear to be averaging about **four to five times normal**, suggesting that CAP is indeed inducing higher risk lending. These loan losses can be handled quite comfortably with the reserves created by the program.

CAP appears to be very successful in addressing the credit needs of small businesses in Michigan. The program has been integrated into the normal lending system in most participating banks, meaning that specialists do not need to be hired to handle CAP loans. Banks find CAP simple and easy to use, allowing them to expand their customer base and learn new markets while maintaining their concern for safety and soundness. CAP helps banks to overcome weaknesses in small business loans, such as poor collateral or limited history, that would have created insurmountable obstacles. The fact that other states have passed legislation creating capital access programs is testimony to the success of Michigan's pioneering endeavor.

different businesses, resulting in the creation of over 10,000 jobs. Second, MCRC has the flexibility to structure investments according to business needs, providing capital in many forms: long-term debt, later stage venture capital for firms experiencing growth, and capital for small firms needing less than $1 million. Most of the investment takes the form of debt made in conjunction with another lender, with or without equity.[17] As a result, MCRC is an important source of risk capital to both traditional and high technology firms. Third, MCRC provided an example to institutional investors that higher-risk investments could be profitable. By working with the insurance industry, the state was able to create a new institution capitalized with $100 million, achieving a scale virtually impossible for a strictly public investment program. Moreover, MCRC is professionally managed by the life insurance industry, not operated as part of the state bureaucracy.

One caution is in order. MCRC has achieved success in targeting medium-sized industries, with more than half the portfolio companies having less than $10 million in revenue. Loans range from $500,000 to $5 million. While the capital needs of these firms in Massachusetts may have been large, the gaps in other states may be different. For smaller firms, the MCRC model may not be appropriate. However, MCRC still represents an important example of a public-private partnership to induce high-risk development lending.

Since the banking industry is regulated at both the federal and state levels, states have an opportunity to require of banks a greater commitment to development lending. Over $6 billion in profitable community development loans would not have been made without the use of the Community Reinvestment Act and its protest provision.[18] A number of states have accepted the challenge presented by CRA. A state Community Reinvestment Act can be used to encourage banks to meet community credit needs, along the same lines as the federal legislation. States may strengthen requirements beyond the federal legislation: the New York CRA provided for the establishment and disclosure of CRA

ratings and served as the model for recently adopted federal disclosure legislation. The importance of disclosure to encourage development lending should not be underestimated. Evidence from Atlanta, Detroit, and Boston suggests that public disclosure of poor community lending performance was the stick needed to prod banks to dedicate more funds to low-income mortgages and other development loans.[19]

Another regulatory option for states is combining interstate or branch banking legislation with **net new funds requirements**. Maine was the pioneer. An out-of-state bank acquiring a Maine institution must provide an initial plan for how it will create net new funds through its lending and investment policies, and then submit annual reports on its performance. However, it is possible for a bank to create net new funds without having much development impact on the local economy or even while it excludes lending to certain groups, such as small businesses.

An alternative is to amend these requirements to specify that net new funds must flow to developmental lending—small, low-income, or minority business loans. Minnesota's interstate banking legislation does just that. Banks seeking access to Minnesota markets must specify what **developmental loans** they are now making and their lending plans for the future. Developmental loans are defined to include loans for low- and moderate-income housing, and minority businesses, student education, and alternative energy. Required annual reports must detail loans made in areas not covered under the Home Mortgage Disclosure Act (HMDA), specifically rural areas. In essence, Minnesota's legislation has **defined priority credit needs** and is directing additional capital toward them. The state has also committed resources for technical assistance and other services to these same target groups, linking development lending with other economic development programs. Again, the emphasis is on changing bank behavior by identifying credit gaps and disclosing banks' performance in filling them.

The emphasis is on identifying credit gaps and disclosing banks' performance

A final regulatory option available to states is the creation of **entrepreneurial portfolios**, which allow

banks to engage in higher-risk lending with less concern for regulation.[20] Under this scheme, banks could develop a small portfolio of loans that they and their examiners considered high-risk, such as loans to small businesses or rural enterprises. These would be evaluated separately from a bank's full portfolio; thus, the bank would be encouraged to make a limited number of higher-risk loans without concern that losses would jeopardize the entire portfolio. The strength of this approach lies in the fact that the bank bears full responsibility for loan losses and is more likely to exercise sound financial judgment in making loans. An important question, however, is whether this regulatory change will be enough to increase capital availability to higher-risk businesses without also increasing the bank's capacity to spread risk, such as through loan insurance or risk pooling programs.

An equally important question is the impact of the savings and loan and banking crises on the attitudes of regulators. Some believe that bank failures have resulted from excessive risk-taking and poor management. Any new initiatives that foster even moderate risk-taking may be difficult to achieve. At the same time, however, the sweeping bank reforms proposed by the Bush administration may provide an opportunity to link increased development lending with expanded banking powers and restructured regulatory authority. These reform proposals would allow banks to expand into new products, such as securities and insurance, and new markets through nationwide interstate banking.

The State as Investor

If regulatory changes or private inducements fail to correct flaws in the market, states may have to intervene. The state can assume the role of investor either **actively** or **passively**. As an **active investor**, the state creates and capitalizes new institutions or programs that increase the supply of development capital. As a **passive investor**, the state plays a more supportive role, investing in existing development finance institutions or non-profit

organizations with financing programs. Whether a state investment is active or passive really depends upon how much capital the state invests relative to other players and how much control the state exercises over the intermediary institution and its decisions. The role the state plays will depend largely on whether intermediaries already exist, whether the state has confidence in their capacity to deliver development capital, and whether they are addressing capital gaps important to state economic development policy.

The Minnesota Community Reinvestment Fund demonstrates the states' abilities to straddle the line between regulatory and investor roles

The Minnesota Community Reinvestment Fund (CRF), which began operating in March 1989, demonstrates the states' abilities to straddle the line between regulatory and investor roles. CRF increases the availability of development capital by supporting community development corporations. These non-profits can fund ventures that banks would ignore. In most cases, their capital base is small and at times may be tied up completely in current investments. Most banks minimize this problem by selling loans in established secondary markets, but non-profits cannot. There is no well-developed secondary market for loans made by these small agencies. Consequently, their effectiveness is limited by the liquidity of their capital base.

To address this need, the Community Reinvestment Fund (CRF) was designed to recapitalize development agencies by creating a secondary market for their loans. The fund purchases loans from community development organizations, then sells **community reinvestment revenue bonds** through private placement to investors. Since its inception, CRF has completed two bond issues, purchasing 202 loans valued at over $2.1 million from community development organizations and municipal governments. Some of the more than $1.5 million returned to the organizations has already been reinvested.[21]

In addition to providing some initial capital for CRF, the state authorized the sale of community development bonds and defined bank investments in CRF as **developmental loans** under the interstate banking law. These changes permitted CRF to attract private capital

into the fund. CRF has targeted socially motivated investors, including some banks, insurance companies and a church pension fund. Through the secondary market, CRF hopes to encourage more private investment in areas experiencing economic decline. To do so, CRF must raise capital for its credit reserve, a pool of funds used as additional collateral for the loans it purchases. Although part of the loan purchase price is contributed to the reserve, CRF must raise additional money to expand its bond issues. CRF continues to raise this money from both public and private sources and is beginning to seek loans from institutions outside of Minnesota.

An example of states' active investor role is the creation of **Business and Industrial Development Corporations (BIDCOs)**, private financial institutions designed to address moderate-risk capital needs. These finance firms that need access to risk capital but are not expected to generate the high returns required by most venture capital companies. BIDCOs have flexibility in the financing tools available to them, blending debt financing with equity and near-equity investments.

The Michigan Strategic Fund's BIDCO program provides a good example of how a state can actively encourage the formation of these institutions (see box beginning on page 39). Enabling legislation was necessary to launch the new program, then the state used the Strategic Fund to provide an initial capital investment, matched by private investment. Technical assistance has been the critical catalyst for establishing several BIDCOs throughout the state. The first seven BIDCOs are expected to provide $400 million to Michigan businesses over the next ten years, significantly leveraging the state's initial investment of $14.5 million.

The BIDCO concept embodies several important principles of development finance. The state uses its resources to leverage additional private lending, increasing the scale of the BIDCO program and thus its developmental impact. The BIDCO concept is flexible enough to be applied to a variety of markets and to meet specific capital needs of small businesses. For example,

Michigan's BIDCO Program

In 1986, the Michigan legislature passed a law permitting the establishment of BIDCOs, Business and Industrial Development Corporations. With the Governor's signature, BIDCOs became a new type of private financial institution, one with greater flexibility than commercial banks. This legislation laid the groundwork for a new Michigan Strategic Fund (MSF) program to invest in newly formed BIDCOs throughout the state. Michigan's BIDCO program is complementary to the state's Capital Access Program in that it tries to meet the credit needs of firms excluded from both moderate-risk bank debt financing and high-return venture capital equity financing. BIDCOs can close this capital gap with a wide range of flexible financing tools.

Unlike commercial banks, BIDCOs are regulated to prevent fraud rather than risk. Consequently, BIDCOs can use a range of financing tools, including subordinated debt combined with some equity financing—for example, warrants to acquire stock or a royalty on future sales. The BIDCO takes greater risk with the expectation of a moderate return as the borrower grows. To manage this risk and help promote growth, BIDCOs provide more technical and business development assistance to their borrowers than a typical bank would provide. This partnership between the BIDCO and the firm in which it invests is a key to the long-term success of both the business and the BIDCO.

The role of the Michigan Strategic Fund is to help catalyze the formation of BIDCOs by providing technical assistance to the organizers and making an initial equity investment of up to $2 million. Initiative for organizing the BIDCO comes from the private sector, with MSF providing information and assistance to the organizers as needed. However, the quality of the BIDCOs management team and business plan are scrutinized by MSF to protect the initial investment, which is contingent upon the BIDCO raising $2 in private funds for every $1 of public investment. In this way,

the program leverages a relatively small public sector investment with substantial equity capital. This private commitment also helps to ensure that BIDCOs are organized where capital gaps exist and, therefore, the expected returns from new investments are high. In this way, the institutional capacity to address moderate-risk financing needs is enhanced.

The record shows that BIDCOs have indeed leveraged additional private sector investment in Michigan. Since 1986, seven BIDCOs have been organized with a total of $42 million in capital, $14.5 million invested by MSF. Through 1990, these had invested $9.5 million in 18 companies, which in turn leveraged $26.1 million from other sources. In addition to these seven, three new BIDCOs have received investment commitments from MSF and are in the process of raising private capital.[22]

Adaptation of the original BIDCO concept to include carefully targeted Minority and Rural BIDCO programs suggests the flexibility of both the institution and MSF. As described in the text, the subsidy component of both the Minority and Rural programs increases as they make more loans to the target groups. The nation's first minority-owned BIDCO, the Greater Detroit BIDCO, began operating in 1990 and has made investments totalling $565,000 in two minority-owned companies.

MSF's BIDCO program shows how a relatively small public investment can be used to help capital markets close critical gaps. The creation of new private financial institutions reflects the state's commitment to working through the market rather than replacing it with a public program. The scale of the program can increase as additional niches to support a BIDCO are identified and private investors are organized. Michigan's program represents an innovative approach to addressing the capital needs of businesses that typically fall through the cracks between commercial lending and venture capital investments.

Michigan created a **Minority BIDCO Program.** Minority BIDCOs have the same institutional structure as the others, but they are more heavily subsidized by the state in two ways. Each minority BIDCO can receive up to $3 million from the state (compared to only $2 million for other BIDCOs), and the loan must be matched by an equivalent amount of private capital, including at least $500,000 from minority individuals. Other BIDCOs are required to raise $2 in private funds for each $1 in public capital. Although minority BIDCOs are not constrained to invest only in minority enterprises or communities, the state encourages such investment by agreeing to convert the initial state loan to a grant if the BIDCO achieves certain standards—for example, job creation or sales growth, or investment in minority firms in distressed areas. The first minority BIDCO became operational in 1990 and has made investments in two minority-owned companies.

The **Rural BIDCO Program** represents another innovation. Recognizing the constraints rural areas may face in setting up a BIDCO—for instance, the need for a larger geographic market to ensure deal flow, the small size of most deals, economic distress in many rural counties—the Rural BIDCO Program has the same subsidy elements as the Minority BIDCO Program. With a rural BIDCO, conversion of the state's loan to a grant can occur gradually as jobs are created and sales increase in rural areas. Greater credit is given for job creation in the most distressed rural areas to encourage targeted financing to areas most in need.

Revolving loan funds (RLFs) allow the state to play the role of active or passive investor. RLFs can meet capital needs that are too small or risky for banks to meet—the returns are not high enough to compensate for the added cost or risk. RLFs are willing to provide capital to these small firms because of the expectation that social or economic development benefits will result from the investment.

These funds are said to be "revolving" because loans repaid to the fund provide the capital for additional loans

in the future. RLFs must be managed professionally to ensure that repayment occurs and the fund is sustainable without subsidy. The state's role in an RLF program can be twofold. First, the state may be involved in establishing revolving loan funds, using either state or federal money to capitalize it. A good example is the North Carolina Microenterprise Fund (NCMF). Second, the state may invest in an existing loan fund, perhaps one established by a private, non-profit community-based organization or a quasi-public agency. Maine's Coastal Enterprises Inc.'s day care RLF (discussed below) provides an example of the latter. In the first case, the state is actively involved in establishing the organizational structure of the Fund, setting its objectives and determining how the fund will be targeted to achieve them. In the second case, the state invests in an existing fund that best reflects its own set of economic development objectives or is targeted to particular populations such as minority or low-income communities.

The North Carolina Microenterprise Fund began as a demonstration project in 1989, following a state-funded analysis of capital markets. Its founders wanted to determine the demand for commercial loans under $20,000, and the role of **microenterprises** in economic development. They designed NCMF to work through established technical assistance providers, who would identify borrowers, provide technical assistance, and make loan decisions. Loan servicing is handled by Self-Help Credit Union, a statewide development bank. The NCMF model combines local decision-making with centralized loan servicing and administration in an attempt to make small lending cost-effective.

To undertake this demonstration, foundations pledged $300,000 with another $500,000 coming from the state. A monitoring and evaluation system ensures that the results of the program can be used to guide future development finance policy. NCMF uses two lending models: group and individual. Under the group lending model, individuals organize borrowing groups to decide who should receive the first loan, to provide mutual support and assistance, and to enforce repayment of the

loans. Other members can receive loans only when the initial borrower establishes a successful repayment record. Loans vary in size, growing from $2,500 to as much as $8,000 as a successful track record is built. Loans are unsecured, one-year-term, at market rates of interest. For the first nine months of the program, 16 groups representing 80 businesses received 36 loans totalling $79,000.

The individual lending model is more traditional, making loans to individual microenterprises. The innovation occurs through the use of volunteer loan committees who operate at local sites throughout the state. These committees include local bankers, accountants, development officials and others who can consider a borrower's character in making a loan decision. The maximum loan size is $20,000; actual loans have ranged from $3,750 to $20,000. For the first ten months of the program, 14 businesses received loans totalling $201,430.

The goal of both models is to use small amounts of capital to encourage microenterprises, particularly in rural communities. Banks have supported the program as an experiment in growing borrowers. Indeed, one objective of both models is to graduate borrowers from NCMF to more traditional lenders. The state has played a very active role in NCMF, setting objectives and investing in the fund along with the private sector. The role of the initial capital market study was critical in the success of this young program. The study identified potential credit needs among a target population and catalyzed state action.

One objective is to graduate borrowers to more traditional lenders

Coastal Enterprises Inc.'s day care Revolving Loan Fund demonstrates another role for the state: supporting an existing RLF. Coastal Enterprises Inc. (CEI), a non-profit organization serving low-income people in coastal Maine communities, was actively involved in providing technical assistance to day care facilities, both family providers and centers. CEI's goals are to create jobs for low-income people and increase the supply of day care slots in the region, particularly for low-income children. One key constraint was the availability of capital.

CEI was able to get $230,000 from the Maine Department of Human Services to match a Ford Foundation grant conditioned on state support. Additional federal and foundation support enabled CEI to create a $1.4 million RLF for its day care clients. It is important to note that the conditional Ford grant served as the key catalyst, for without the state funding, much of the remaining capital from out-of-state sources may not have been available.

Since the state appropriation in Spring 1988, the RLF has supported 45 enterprises, with loans ranging from $1,500 to $150,000. A total of 1,400 new day care slots have been created with one-third allocated to low-income children. All of the enterprises also received CEI's technical assistance, a necessary ingredient to the success of the projects.

This model shows how the state can support an ongoing effort to help a particular target group, in this case low-income individuals. State funds were used to leverage federal and foundation resources, along with about $3 million in private bank financing. The key component of the project, however, was CEI's understanding of the local day care industry and its credit and technical assistance needs. This model requires an **entrepreneurial financial intermediary**, a role better left to a local organization like CEI rather than the state.

An analysis of RLF performance across the country suggests the important role it can play in meeting the capital needs of firms with significant capital access problems, particularly small firms, start-ups, minority- and female-owned enterprises.[23] RLFs are more likely to succeed if they:

1. Develop targeted strategies for lending based on a thorough understanding of capital needs.

2. Pursue higher-risk ventures that are less likely to receive conventional financing, so that the RLF increases capital availability rather than simply substituting for private financing.

3. Aggressively manage this higher-risk portfolio by monitoring problem loans and providing assistance to business owners to avoid loan defaults.

These principles help to move the RLF model closer to the **Third Wave** approach to development finance. As the two programs described above demonstrate, the state role is to invest in financially sound RLFs that support the state's economic development objectives, or to create new institutions that can achieve the same purpose.

Since states do not have a monopoly on innovation in development finance, existing private development finance institutions should be viewed as vehicles for state investment. Development banks, development credit unions and community development loan funds are three vehicles to promote economic development by addressing the capital and technical assistance needs of firms and individuals who are not served by traditional finance. Unlike other private investors, development finance organizations consider both private and social returns in making investment decisions. They provide **patient capital**: they are willing to forego high returns in favor of achieving some long-term developmental impact in the community or state. In this sense, development financiers differ significantly from traditional lenders and must be evaluated differently.

Several good examples of these institutions exist. Self-Help Credit Union in North Carolina (see box beginning on page 46) is an example of a successful, statewide institution with a particular focus on low-income and minority individuals. Southern Development Bancorp in Arkansas is a development bank focused on meeting the credit needs of low-income individuals in rural counties (see box beginning on page 48).

These institutions suggest the important role the private sector has to play in development finance, but where does the state fit in? The state here is a **passive investor**. Through an initial investment in a loan fund or deposits in a development bank or credit union, the state can provide the capital required to leverage private investments. The

Center for Self-Help

The Center for Self-Help was established in 1980 to assist disadvantaged people in North Carolina, particularly women and minorities, by creating economic opportunities and social justice. Four years of providing advice and counsel led the Center to create the Self-Help Credit Union and Self-Help Ventures Fund, thus expanding the Center's role to that of capital provider. Self-Help became the country's first statewide, private development finance institution and "North Carolina's only statewide group providing technical assistance and financing to create jobs and housing for low-income people."[24]

Self-Help Credit Union (SHCU) is a federally insured, regulated financial institution that has grown from $77 in initial assets to over $25 million by 1990. SHCU can receive deposits from individuals and institutions, many of whom are willing to accept lower-than-market interest rates so that SHCU can engage in higher-risk lending. Since credit unions in North Carolina have authority to make commercial loans, SHCU has focused on making loans to its target populations—female- and minority-owned businesses, particularly in rural areas.

Self-Help Ventures Fund (SHVF) is a non-profit revolving loan fund that provides both debt and equity financing, with a focus on small, employee-owned businesses in North Carolina. As a non-profit enterprise, SHVF receives tax-exempt contributions from individuals, religious organizations, foundations and corporations. Contributions are used to support the operation of the Fund, subsidize its technical assistance and make loans. By 1990, SHVF had $2 million in capital. SHVF makes loans or investments of up to $85,000 and will collaborate to gain additional capital as needed. Generally, SHVF extends long-term, secured debt, working with clients to insure an appropriate repayment schedule. Equity and near-equity investments can also be made under special circumstances, with repayment within five years.

The Credit Union and the Ventures Fund form the basis of

the Self-Help Development Bank. Together, these institutions have made over $13 million in housing and commercial loans, with over one-third of themgoing to commercial enterprises. In 1988, Self-Help received a $2 million appropriation from the General Assembly to support its loanprogram. Unlike conventional financial institutions, Self-Help is able to attract outside financial support, particularly from foundations, to cover the costs of additional technical assistance for its borrowers. It is able to make loans that are smaller or higher-risk than a typical bank would make, because of the extra time it invests in counseling borrowers both before and after making a loan.

Self-Help works closely with other development organizations in the state. It originates and services loans made by local organizations under the North Carolina Microenterprise Fund described in the text. It also provides technical and financial assistance to non-profit organizations in the process of establishing community-based revolving loan funds. These activities, coupled with its advocacy before the legislature and administration, increase Self-Help's statewide impact on economic development. A recent demonstration of Self-Help's success was the appropriation by the General Assembly of $6 million in capital for a comprehensive rural financing program administered by Self-Help and other locally controlled economic development organizations.

Recognizing Self-Help's importance as a force for economic development, the state has helped to increase the supply of development finance to groups and regions lacking access to capital. Self-Help, in turn, has worked hard to meet its economic development and social justice objectives while sustaining two professionally-managed financing arms through prudent development lending and successful marketing of its programs to foundations, individuals and public sector investors.

Southern Development Bancorporation

Southern Development Bancorporation (SDB) is a bank holding company established in 1986 to promote new economic development initiatives in several rural Arkansas counties. SDB has three subsidiaries: a commercial bank, a for-profit real estate development company, and a non-profit corporation. SDB is a **development bank** patterned after Shorebank Corporation, a holding company that has successfully encouraged reinvestment in a low-income Chicago neighborhood for the past fourteen years.

As a development bank, SDB's objective is to create economic opportunities for low-income, rural Arkansans. In order to meet its objective while establishing an immediate presence in the community, SDB purchased a local bank which provided conventional services but had limited capacity in development lending. SDB introduced a Development Loan Officer with specific responsibilities for making local economic development loans. With a loan officer trained to consider economic development impacts along with risk and rates of return, the bank's capacity to act as a development lending institution increased. Thus, this is an instance in which sound principles of development finance appear to be served at least in part through the offices of a conventional lending institution that was already in place.

The other primary outlet for the development lending activities of SDB is the not-for-profit subsidiary, Arkansas Enterprise Group (AEG). AEG was established as a vehicle for providing both capital and information to low-income rural residents in the target communities. AEG operates four programs designed to address the range of capital and information needs of small businesses and entrepreneurs. A venture capital company, operated as a Small Business Investment Corporation, can provide needed equity capital to small businesses in the start-up and expansion phases. The Good Faith Fund is a revolving loan fund that

provides very small, short-term, unsecured loans to residents, following the peer group lending model successfully implemented in other countries, such as Bangladesh. The peer borrowing groups are assisted by eight loan representatives working in the field. Loans are made to encourage self-employment or to augment income from other sources. The Seed Capital Fund is focused on making small loans to entrepreneurs who are in the product or marketing development stage. Finally, technical assistance to businesses served by AEG's financing arms is provided by AEG Manufacturing Services, which provides manufacturing, marketing, and management services to small businesses. Fees are charged in order to increase business access to the technical and management skills needed for successful business development.

Much of the initial impetus for the creation of SDB came from the Winthrop Rockefeller Foundation, which made an initial capital equity investment of $2 million followed by a long-term loan at below-market cost. Other foundations and investors have committed both equity and long-term loan funds to help capitalize SDB. To date, $6.5 million in capital has been raised with $3 million in grants and permanent capital to support AEG's programmatic activities.

The state's role in the creation of SDB has been to provide the political support needed to gain capital commitments from other Arkansans. The Governor was an early and active supporter of SDB, providing political acceptability to the development finance concept in Arkansas. In addition to this supportive role, the state also played a passive investment role through a quasi-public agency, the Arkansas Capital Corporation. ACC made a $300,000 investment in SDB common stock—an important departure from its history of fixed asset investments to support industry locations. Beyond this involvement, however, the state has not played an active role, although there has been joint participation on individual business deals. For example, a state economic development agency provided a grant to an organic vegetable demonstration farm that SDB was financing. The Arkansas Capital Corporation and SDB have both been involved in supporting a few manufacturing enterprises.

Although the state has not played a major role in SDB's activities in recent years, this case does suggest the importance of state political support for private development finance institutions. The Governor's enthusiastic endorsement provided the impetus and opened doors to potential investors who made capitalization possible. This case shows that state support need not be restricted to capital investments. In states where capital may be limited, policy-makers should actively explore other means of supporting private sector initiatives that help the state reach its economic development goals, following the lead of Arkansas and the Southern Development Bancorporation.

state can also assist these institutions without investing money, by creating tax credits and other incentives for private investors to place their funds in development finance institutions. Finally, the state can recognize the economic development impact of these institutions and more effectively use them as vehicles for achieving state policy. By supporting these organizations with grants for operating funds or through deposits, the state can spend its scarce resources directly on economic development rather than creating redundant, ineffective new programs.

The State as Direct Provider

There may be circumstances when the state is unable to move capital to target groups, either by correcting market failure or investing in development finance institutions. Moreover, under some economic conditions, such as those currently faced by many New England banks, the state may not be able to induce more private lending. In these instances, the state must assume the role of direct provider to ensure that a lack of credit does not constrain economic development. While this is a less desirable role for the state—in some ways a regression to past practices—it may be necessary to meet the capital needs of high-priority groups or regions.

Massachusetts has one of the oldest state agencies involved in direct lending, the Community Development Finance Corporation (CDFC). CDFC provides flexible financing by working through the state's network of private community development corporations (CDCs). Funds are channeled to businesses with job creation potential to ensure that public benefits occur. The program addresses capital gaps by concentrating on firms that have been unable to obtain private financing. CDFC has the flexibility to make both debt and equity investments, with the local CDC providing financial as well as technical assistance to the business. Although the size of investment typically made by CDFC is small by venture capital standards ($75,000 to $300,000), it is quite large in relation to the needs of many small businesses

and start-up ventures. As a result, CDFC is not effective in meeting the credit needs of microenterprises requiring less than $20,000 in capital, including many businesses in rural western Massachusetts.

CDFC had trouble managing its initial portfolio (see box beginning on page 53). Moreover, the local community development corporations' limited experience with small business finance—until then, CDCs had been involved in housing and real estate development—hindered CDFC's performance. In recent years, however, CDFC management has evolved to address some of these problems, and the more recent lending experience has improved. Still, CDFC continues to face some of the problems of the first development finance institutions because of its strong ties to the state bureaucracy and the difficulties local CDCs have encountered in venture development.

Another example of a direct lending program appears in Illinois to provide subordinated debt financing to small businesses. The state provides up to 25 percent of the backing for a small business, working with a private financial institution to obtain the rest. State funds act like a second mortgage for the borrower and increase the chances of private financing. To ensure public benefits, state funds are used only to help firms locate or remain in the state, thus creating or maintaining jobs. The program is administered by the Illinois Bureau of Small Business and received annual appropriations from the legislature (fiscal years 1986 through 1990) totalling almost $37 million. These funds were used initially to make direct term loans, from three to twenty years, to businesses with fewer than 500 employees. State loans, made in partnership with banks and savings banks, have leveraged private capital by a 3:1 ratio over the life of the program.

The statute creating this program was flexible enough to permit changes based on newly identified credit needs. In 1986, soon after the program was initiated, administrators observed that the credit needs of microenterprises were not adequately served under existing guidelines. As a result, they created a new

Community Development Finance Corporation

The Massachusetts Community Development Finance Corporation (CDFC) is one of the oldest state agencies involved in direct lending programs. CDFC is a state-owned corporation providing flexible financing for businesses and real estate development projects with clear public benefits. The program works with the existing network of private, non-profit community development corporations (CDCs) operating in Massachusetts. Since its initial capitalization in 1975, CDFC has received $15 million from the state. In 1990, its investments totalled over $13 million. CDFC is operated as a quasi-public agency, so it does not receive an annual state appropriation to support its activities. Instead, it depends on income from its investments and funds accessed outside of state agencies. CDFC also undertakes public-private partnerships to make investments that yield substantial public benefits, particularly employment. Its investments have been made in about 100 small businesses, leading to the creation or retention of over 2,700 jobs in the state.

Two of CDFC's programs focus specifically on business lending. The Venture Capital Program provides debt and equity financing to small businesses that will create employment and for which no private funds are available. The business opportunities must be located in a CDC target area and have the support of the local CDC. While direct investments range from $100,000 to $250,000, CDFC typically works with local financial institutions to provide additional funds. Any equity position taken by CDFC is in conjunction with the local CDC. CDFC can provide up to one-third of total project financing. The Small Loan Guarantee Program focuses on increasing credit opportunities for start-ups or young firms. CDFC can provide a loan guarantee, again working through a local CDC, of 50 percent or up to $25,000 of an approved bank loan to a small business. The guarantee serves as additional collateral for the bank, making a deal bankable.

CDFC's current record does not reflect its initial difficulty in making sound investments. CDFC lost $4 million of the first $6 million it invested. Loss rates for its first four years ranged from 40 to 85 percent. One problem faced by both CDFC and the local CDCs was the lack of management capacity to make and monitor sound investments devoid of political influences. Without oversight like that found in private venture capital companies, CDFC had less control over its portfolio and, consequently, a poor track record in creating viable enterprises and jobs. CDFC and the local CDCs had neither the skills nor the commitment to offer sound technical assistance during the program's early years.

Performance in the past few years has improved, primarily because of a change in management and the recognition that entrepreneurs need more than capital to succeed. Part of CDFC's turnaround can be credited to developing working relationships with bankers, thus increasing public-private partnership investments in small businesses. In addition, the new president was aggressive in requiring technical assistance for business clients, using trained advisors to assist them. CDFC's experience highlights the importance that management plays in the success of a development finance program and the critical role of technical assistance in helping businesses and the program itself achieve their objectives.

CDFC's recent experience reflects the success of the new approach to development lending. Loss rates during 1984, the first year under new management, declined to about 6 percent, although losses are expected to be 10 to 11 percent in the future.[25] These rates are in line with those experienced by other development finance programs. As noted in the text, loss rates for development finance programs should be higher than commercial bank loss rates if the development finance program is achieving its objective of serving higher-risk, small business borrowers. CDFC's experience, however, suggests the importance of controlling those losses by designing a direct lending program that closely parallels successful private institutions. This structure requires active involvement by the state agency in managing its investments and working with small businesses and CDCs to insure successful investment.

program in which a certain portion of the loan funds were set aside to finance firms requiring less than $100,000. Later, in 1988, adaptations resulted in financing businesses owned by minorities and women.

Over the past five years, the program has made 198 loans: 78 (totalling $31 million) to small businesses, 71 ($4.4 million) to microenterprises, and 49 ($1.7 million) to minority and female entrepreneurs. To help make this program sustainable, even without additional state appropriations, loan repayments were used to create a revolving loan fund of over $15 million. The last state appropriation was made in FY 1990; in early 1991, the RLF offered its first loan.

The Illinois program shows how state funds can be loaned directly to meet specific credit needs while leveraging additional private capital. Leveraging is important since it helps to address the problem of scale associated with most state loan programs. In addition, the program demonstrates how flexibility in program design can help meet credit needs as they become priority objectives for state policy. Finally, combining a state direct loan program with a revolving loan fund helps to ensure some measure of sustainability and serves as a buffer against changes in fiscal or political circumstances.

Another example of a state direct financing program is the Massachusetts Technology Development Corporation (MTDC). MTDC was created in 1978 to address the capital gap for expanding, early-stage technology companies. These were not targets for private venture firms because they were too small, needing less than $1 million in equity, and in the earliest stages of commercializing their products. MTDC makes equity investments of up to $1 million in high technology start-up companies. MTDC does not finance product development, as do some technology centers, but rather invests in firms seeking to expand operations to commercial scale. Since most venture capitalists have ignored these early-stage firms, MTDC is complementing rather than substituting for private funds.

MTDC received federal grants of $3 million to begin operations, followed by state appropriations of $4.2 million from 1981 to 1989. Recently, the capital base has been augmented by gains from MTDC investments and now stands at almost $13 million. Best of all, MTDC has become self-sufficient: it has received no state or federal grants since 1988. Through 1989, MTDC has invested $14.7 million in 50 Massachusetts companies and has exited from 24 of these initial investments, either through acquisition of the firms, buy-back of stock, or private offerings.

One criticism of any state direct investment program is its limited scale of impact. MTDC's almost $15 million in equity investments pales in comparison to private venture capital investments of billions nationally during the 1980s. However, private venture firms are not meeting the needs of the businesses MTDC has chosen to address. Significantly, MTDC's investment leveraged $68 million in private funds at the time of their initial investment. Subsequently, MTDC firms have gone on to raise another $155 million in capital. At the end of 1989, the 41 active companies in which MTDC had invested employed over 4,400 people.[26]

These figures suggest that MTDC has been successful in meeting its economic development objectives: to create employment in technology-based industries; to leverage private investment; and to encourage entrepreneurship, leading to long-term economic development in Massachusetts. This last objective has been addressed directly by MTDC's Management Assistance Program (MAP). Under MAP, MTDC staff help entrepreneurs even when MTDC does not make a direct capital investment, by developing business plans, identifying feasible ways of raising capital, and helping to locate funding. MAP helps reduce the transaction costs to private investors who may then be induced to invest.

Technical Assistance—
A Guiding Principle for Development Finance

While many characteristics distinguish development finance from more traditional lending programs, **technical assistance to small business borrowers** must be viewed as one of the guiding principles of development finance. Most development finance programs focus on weaknesses in both the demand and supply sides of local capital markets. By definition, development finance aims to increase capital availability for entrepreneurs who do not have access to private capital markets, for many of the reasons discussed earlier. In most cases, however, helping business clients prepare business plans, put together adequate financial statements, and think through their financing needs facilitates their access to capital, either from a private lender or a public program. The future success of that entrepreneur depends to a great extent on maintaining a relationship with the technical assistance provider so that small problems are handled quickly and do not become insurmountable obstacles.

Many of the **best practices** described earlier include a well-defined technical assistance component along with the provision of capital. Indeed, one important criticism of states' direct lending programs has been the lack of technical assistance and follow-up with borrowers to help ensure the success of their businesses. The private sector models presented—North Carolina's Microenterprise Fund, CEI's day care RLF, Self-Help Credit Union, and Southern Development Bancorp—link technical assistance with financing to meet development objectives. The experience of these programs demonstrates the success of this linkage.

Some states clearly recognize the importance of technical assistance in development finance programs. One is Michigan's **Northern Economic Initiatives Center (NEIC)**, which serves entrepreneurs and small businesses in Michigan's Upper Peninsula. NEIC's programs include technical assistance through a Small Business Development Center, evaluation of a firm's

current technology, loans for modernization, and product promotion and distribution. The center is located at Northern Michigan University and can draw on university faculty as needed. NEIC relies primarily on state funding, using private funds to support particular research or application projects (see box on page 59).

The Small Business Development Center (SBDC) within NEIC is part of a network of centers operated in most states. SBDCs are sponsored by the U.S. Small Business Administration (SBA) and link private, public, and university resources. SBDCs provide business management assistance to those who cannot afford to purchase these services from the private sector. While SBDCs do not provide direct financing to entrepreneurs, they offer a wide range of business services, such as accounting, marketing and financial planning. They work to improve planning and management, hopefully making bank financing more likely. In addition, they may help identify less traditional sources of financing—venture capital or quasi-public sources of capital—once a business plan is developed.

There may be problems with the SBDC concept applied to state development finance. Often located at universities, SBDCs may be isolated from the entrepreneurs who really need their services. In some states, local community development organizations, such as CEI in Maine, serve as SBDCs, connecting business assistance and sources of financing directly with small business clients. Such modifications in the SBDC concept can improve its effectiveness.

Another problem may arise when SBDC performance is evaluated on criteria unrelated to economic development objectives. For example, an SBDC may be judged by the number of clients served or business plans developed, rather than the number of successful business deals completed or jobs created in a target area. If the center is performing to meet some numerical criteria established by the Small Business Administration, without consideration of the state's development finance objectives, it may not provide the type of business

Northern Economic Initiatives Center

The Northern Economic Initiatives Center (NEIC) was established by Northern Michigan University in 1985. Its mission is to improve the competitive position of small firms in Michigan's Upper Peninsula through a combination of training, information, counseling and encouragement. The center receives state funding supplemented with private funds to support specific programs. Funding for NEIC has grown from about $300,000 in 1985 to over $600,000 in 1990, with much of the increase coming from local private sources.[27]

NEIC has five primary components. The **Small Business Development Center** (SBDC) is NEIC's primary source of new business contacts. SBDC staff provide both short- and long-term counseling to small business clients and offer business development seminars throughout the region. Counseling hours have increased from 360 in 1986 to 3000 in 1990.

Market Services offers assistance in analyzing the potential of new products, assessing alternative marketing approaches, and even test marketing. These services are available for a range of business enterprises, with particular emphasis on developing cottage industries. The promotion of these "micro-industries" is one of NEIC's unique features.

Through **Industry Services**, NEIC creates networks of firms in regional industries such as maple syrup, frozen foods and secondary wood processing. These networks help build supply, service, innovation, market, and management relationships for participating firms. The network relationships help smaller enterprises deal with critically important issues of insurance, purchasing, transportation, and employee training, where a business' small size can be an impediment.

NEIC's research arm, the **Northern Data Research Institute** (NDRI), provides information to private and public sector decision-makers who may be considering investments within the region. NDRI provides general economic

information about northern Michigan, as well as more detailed market research to support NEIC's other activities.

The final component is **Field Services**. NEIC staff assist both small and large firms in auditing current production practices through on-site visits and follow-up consultation. The objective is to recommend changes that will reduce costs and maintain competitiveness.

NEIC also administers a group loan fund, averaging eight loans of $5,000 per year to small firms in the region. An Upper Peninsula Venture Capital Network matches entrepreneurs with informal venture capital investors. The Network serves an important function in filling capital gaps in the region since most start-up enterprises would not be aware of these potential investors.

NEIC's programs are unique because they go beyond traditional technical assistance to include product and market development, technology transfer and potential sources of debt and venture capital. Since most of NEIC's staff have previously owned small businesses, they bring professional experience to their assistance efforts. In addition, the partnership with Northern Michigan University helps to establish the role of higher education in rural economic development, enhancing state resource availability to address key rural development issues. While NEIC's scale constrains its overall economic development impact, its regional focus means that resources are concentrated among a relatively small number of potential enterprises. Moreover, NEIC staff can specialize in particular industries common to the region, rather than becoming fluent in a wide but less focused range of industry problems and opportunities. Perhaps most importantly, NEIC's experience suggests a role the state can play in encouraging institutions of higher education to commit their resources to meeting local economic development needs. If NEIC's experience were replicated by a number of institutions throughout the state, each combining state, federal, and private funds to foster economic development, the scale of impact would be much greater.

development cultivation and follow-up that is required to support a successful state development finance program.

These criticisms suggest that modifications in the SBDC structure, such as those found in Michigan's NEIC and Maine's CEI, may be necessary to make it a more appropriate development finance tool. In addition, both the objectives and criteria used for evaluating SBDCs should be consistent with those established for state development finance programs so that the two efforts are mutually supportive.

In addition to enhancing an entrepreneur's business management skills, programs should also try to increase the effectiveness of public sector suppliers to meet small business credit needs. The National Development Council (NDC), a private non-profit organization, has focused its attention on providing such assistance as a way of increasing small business access to capital for expansion and, consequently, job creation. NDC works with cities and states to evaluate development projects and determine what private and public resources are needed to make a deal work. NDC also trains economic development officials to use existing development finance programs, such as SBA and state Community Development Block Grant programs, more effectively. By working closely with state and local officials, NDC is able to increase staff capacity to analyze small business deals and structure loans to make deals move forward. In more recent years, NDC has begun to address the demand side, training entrepreneurs in the basic skills of financial management and analysis.

The NDC model differs from many of the technical assistance components of private development finance programs. NDC began with a strong focus on working with public sector people to enhance their capacity in financing small businesses. Thus, this technical assistance model focuses on supply-side capacity needs, an issue that has received much less attention than technical assistance for individual entrepreneurs. As states consider ways to enhance development finance initiatives, the need for the kind of capacity-building provided through the NDC model should be considered.

Chapter 5. Mustering Political Support for Development Finance Programs

Getting Started

The first step in building political support for development finance programs is **documenting the need.** State politicians and private sector partners must see the evidence that calls for a development finance program. Designing an appropriate intervention and selling the program to the public will also be served by documenting need. The capital market analysis can be used to generate some galvanizing statistics to capture the attention of politicians and citizens—for example, the percentage of new jobs created by the state's small businesses.

Next, create a **task force, legislative study commission or citizen's commission** to study the problem. If a study has already been completed, this group can work to design the appropriate program. As the group convenes, it is important to keep in mind that it represents a new coalition that will bear much of the burden for gaining political consensus for the program. Members of the coalition should perhaps include local bankers, small business people, economic development practitioners, members of the Chamber of Commerce, business groups, community development organizations and other intermediaries, legislators and public officials, representatives of appropriate state agencies, and consumer groups. It is important to recognize the trade-off in drawing members from a wide group of interests. People with very diverse interests or agendas may have trouble reaching consensus on the nature of the problem and how best to address it. Once they gain consensus, however, selling the program to the public and implementing it will both be easier. One possible solution to the dilemma of consensus calls for a two-stage process. First, convene a fairly diverse group to identify the problem and build political support for a solution. Second,

identify a smaller group of key actors to negotiate among themselves to devise the intervention strategy.

Targeting the Program

A targeted program may best achieve state economic development objectives, but targeting must be considered from a political perspective. What is the best way to gain broad support for a narrowly-defined development finance program? Several important targeting issues must precede implementation of the program: geography, industry sector, and business size.

Geographic targeting typically involves the question of whether to design a statewide or rural program. The need for rural development finance is generally much easier to document but much harder to sell politically, since rural quarters usually include fewer legislators and fewer areas to benefit. A statewide program may be more palatable politically, but the need may be more difficult to document. Private sector intermediaries often argue that they are already meeting particular credit needs statewide, if only in some isolated markets. Moreover, the impact of a statewide program is likely to be diluted. Sophisticated urban firms may be better able to compete for scarce funds, leaving small rural enterprises credit-shy once again. One compromise is to explicitly identify depressed rural firms, sectors, and communities as target populations in the enabling legislation for a statewide program. In some states, the best political strategy may be to target a well-known depressed region.

One compromise is to explicitly identify target populations in a statewide program

A related issue involves targeting a specific **industry sector**. Unless an industry is of overriding importance to the state—agriculture, high technology and manufacturing are common examples—it may be politically difficult to single it out for assistance, particularly when other industries may be suffering as well. Still, some development finance models may be successful **only** when targeted to particular industries, such as we saw in MTDC's focus on early-stage high technology companies. Combining

targeting strategies to achieve specific objectives may be the best bet. It may be easier politically to target traditionally rural industries as a way of creating a rural finance program, thus increasing capital in those areas.

Finally, the **size of firm** eligible for financing must be weighed. Programs targeted to microenterprises may address critical capital gaps but may be difficult to sell. Entrepreneurs in these very small businesses are not well-organized and may be hard to identify and mobilize before the program gets off the ground. Programs targeted to start-up firms will have, by definition, no identifiable group of business people to organize for support. Consequently, one must consider ways to encourage support (or at least neutrality) from other small businesses, many of whom may not benefit directly from the program. Once again, the ability to document both the need and the economic development potential of the program is crucial to garnering support from the state's business sector.

The attitude of bankers is an over-arching concern

The attitude of bankers is an over-arching concern in any development finance initiative. If bankers feel they will benefit from the program, they may see that their best interests are served by supporting it. Targeting may help. For example, bankers may be persuaded that a program to capitalize start-up businesses will cultivate future business borrowers. If the banking industry does not come forward with immediate support, some sort of **quid pro quo** may be necessary to blunt its opposition. Bank lobbies tend to be well-organized and carry significant clout; striking a deal before the program comes up for political debate may be the best strategy. A number of carrots and sticks may be used to win bankers' support.

Structure and Control of the Program

Who will run the development finance program? How will it be structured? How will economic development and financial objectives be maintained? These questions relate to the nuts and bolts of implementation. The answers are critical to securing strong political support.

A board or advisory committee may be the key to solidifying political support. The make-up of the board demonstrates that the appropriate interests are represented and that no key actors have been left out. Including bankers on the board of a direct loan program will neutralize much opposition. By including supporters as well as potential opponents to the program, the board serves to overcome political obstacles as they arise.

State programs structured in partnership with the private sector provide political advantages beyond leveraging additional capital. Both the public and private sectors can take credit for program benefits. If success does not come, they can share in the failure, making both parties less vulnerable. Partnership with banks in particular helps to overcome potential opposition by bringing in the private sector as an active partner.

The choice between creating a new intermediary and working through an existing one is especially delicate. Using an existing institution—modifying its objectives to meet state economic development needs—may create fewer turf problems and less opposition. The state is then not guilty of substituting for the private sector. But do appropriate intermediaries exist, and are they committed and flexible enough to meet the state's economic development needs?

Partnerships with the private sector offer numerous advantages: management expertise, professionalism, and insulation from political pressure in deal analysis, to name three. These same advantages often apply to private development finance as well. But how can one be sure that a private organization will be accountable to public objectives—for example, to meeting the credit needs of a target population? Unless accountability can be ensured from the outset, the program may not get the political support it needs to get off the ground.

Accountability can be designed into programs

Accountability can be designed into programs in a number of ways. First, the board can include representatives of either target populations (small businesses, for example) or their advocates (community

development organizations). Such representatives can be trusted to focus public attention on abuses of purpose.

Second, mandated reports to the legislature or some appropriate state body can provide the information necessary to monitor and evaluate performance. Recognizing the need for these reports, program designers can establish monitoring and data collection systems to facilitate evaluation. Legitimate concerns about public access to sensitive lending data can be met without violating confidentiality. A good way to do so is to focus reporting on program objectives without disclosing the identities of borrowers. For example, reports can include data on the number, sizes and geographic locations of loans, and the sizes, locations, types of business borrowers, purposes of loans, jobs created, and private funds leveraged.

Third, public-private partnerships do not necessarily demand hands-on management and decision-making on the part of public agencies; rather, their role can be limited to oversight. Public sector staff can participate on a board or through some other formal arrangement and thus be actively involved in defining objectives, monitoring progress and evaluating overall performance. Similarly, ongoing public support can be made contingent on meeting specific performance standards which are explicit from the inception of the program and consistent with overall objectives.

Development finance programs must address capital gaps that clearly limit economic development

A final point about the structure and control of a development finance program is this: A recurring theme throughout this discussion is the need to relate development finance to the state's (often the governor's) overall economic development strategy. If development finance programs are to go beyond what the private sector can do, they must be designed to address capital gaps that clearly limit economic development. These programs must be guided by a set of **development objectives** related to and supportive of economic development activities in general.

Cost and Burden of the Program

In choosing a development finance program to meet a state's needs, two politically important questions are these: what will it cost and how will it be paid for? Ignoring these questions may doom the program. Several observations may be helpful in considering them. First, regulation is cheaper than creating a new program or funding an existing one. From a political standpoint, regulation can be presented as the **cost-free** alternative, perhaps increasing its acceptability in an era of deregulation.

Second, other inducements such as tax incentives, linked deposits and public guarantees are also politically easier than funding a new program. While these options carry costs, the costs are usually less tangible and do not require large, additional appropriations.

Third, it is usually more acceptable politically to provide funding for capital rather than to support the operating expenses of a new or existing intermediary. Generally, a capital commitment is a one-time event, while political support for operating expenses must be mustered annually. These same arguments also suggest greater political support for making a capital commitment to an existing intermediary rather than creating a new one. Supporting a new intermediary usually requires both a capital infusion and operating expenses for several years, perhaps indefinitely.

Fourth, regardless of the intermediary, getting high leverage from a public capital investment is politically appealing.

And fifth, if the capital infusion can be used to create a **permanent** source of capital—for instance, a revolving loan fund like the one created in Illinois—the political acceptability is likely to be quite high.

While these insights may be helpful in mustering political support, the best advice may come from anecdotes depicting the **political marketing** process at work in a real state situation. As the story accompanying

this text suggests, political work is utterly crucial to successful development finance programs. Identifying capital needs and choosing among program alternatives are just two steps in getting a development finance program moving. Laying the political groundwork and garnering support may be the toughest part of the task.

Creating a New Program in North Carolina

In the mid-1980s, the North Carolina Lieutenant Governor and the General Assembly empowered a high-level Jobs Commission to improve jobs and economic growth. One of the Commission's recommendations was the creation of a policy and demonstration organization focused specifically on rural economic development. Thus, the North Carolina Rural Economic Development Center (REDC) was founded. A private non-profit corporation, it has received roughly $2 million per year from the General Assembly and modest foundation and corporate funding.

With the assistance of MDC Inc., a non-profit research organization, REDC set out to identify critical problems facing rural communities, governments and businesses. The leading issue that surfaced from an extensive survey of community leaders, development professionals and public officials was lack of capital for small businesses. Despite widespread agreement on the overall problem, no consensus emerged on the precise initiatives needed to address rural capital gaps. Furthermore, several earlier attempts to create a rural development finance mechanism had failed due to faulty design and opposition from both the banking community and state development officials.

Thus, REDC decided to begin the process with a comprehensive rural capital markets analysis. Learning from the failure of earlier efforts, REDC formed a broad-based advisory committee that included representatives from banks and S&Ls, the legislature, the State Treasurer's Office, executive agencies, the business sector and community groups. Recognizing that the task was as much a political as an analytical one, REDC selected a well-known consulting firm with extensive experience in helping state governments and banks design and implement development finance programs. The consultants had worked previously in North Carolina and knew a number of the key decision-makers and potential opponents.

The analysis involved three components. First, the consulting firm collected and analyzed data on banking trends and lending patterns. This step, though politically useful, yielded little hard analysis of business capital gaps, due in part to the dearth of detailed data on commercial loans. The second step involved interviews with nearly 40 leading bankers, economic development officials and development finance professionals. In seeking their perceptions on capital gaps and how they might be filled, the consultants were able to obtain some key supporters for the study's final recommendations.

The third component consisted of structured interviews with about 100 small businesses in rural areas across North Carolina. When leaders of the community college-based Small Business Centers and the regional SBA Certified Development Companies expressed concern that they had not been adequately involved in the analysis, the consultants requested that they assist in designing and carrying out this component. Their participation helped give these important small business assistance providers a sense of ownership in the process. While the interviews did not yield extensive hard data on capital gaps, they did uncover several striking examples of small firms that had been unable to grow at key points due to inadequate equity and higher-risk debt financing. These anecdotes proved very useful in the subsequent General Assembly process, to illustrate the problems in ways with which rural legislators could identify.

The consultants' report, completed in April 1988, documented that North Carolina was blessed with a very healthy banking sector and a relatively large number of in-state development finance entities and venture capital firms. However, it concluded that rural capital access was weak in several respects, the foremost being a lack of affordable, long-term financing for the growth, technological modernization or new product and market development of small and mid-sized companies. The study's central recommendation was to create the North Carolina Enterprise Corporation (NCEC), an independent, private, for-profit development finance organization to be jointly capitalized by the State and

private investors. NCEC would provide mezzanine financing (relatively high-risk debt and equity capital) to firms that were too risky for conventional bank financing but were inappropriate for venture capital investments due to their small size, inability to offer typical venture capital returns, or unwillingness to give up an ownership stake.

A second gap identified was the availability of smaller loans (in the $20,000 to $50,000 range), particularly for businesses owned by women, minorities, non-profits and other non-traditional entrepreneurs. The higher transactions costs and resultant lower profitability of loans of this size reduced the amount of bank financing available. To close this gap, the report noted the existence of a private non-profit intermediary targeting this niche, the Self-Help development bank, through which the State could play a passive investment role.

A final conclusion, which was not in the original draft of the report but emerged from discussion with community activists and development professionals familiar with problems in minority and low-income areas, was the lack of very small loans (in the $500 to $20,000 range) for self-employed individuals and very small enterprises. The report recommended the creation of a demonstration program to make microenterprise loans and to experiment with alternatives to traditional underwriting practices in order to minimize the risk and transaction costs of making tiny loans to individuals short on collateral.

The advisory committee for the rural capital markets study ratified the recommendations and key actors were committed to seeing that the recommendations —particularly the creation of the Enterprise Corporation—were acted upon. For the Enterprise Corporation to become a reality, two central parties had to be persuaded: the banking community and the State Treasurer's office. As originally envisioned, the Enterprise Corporation was to be a $100 million fund: $20 million of stock purchased by banks and other institutional private investors, $20 million of stock purchased by the State, and a $60 million line of credit extended by the participating banks.

As a first step in getting the banks bought in, REDC approached key leaders of the North Carolina Bankers

Association (NCBA). The president of Branch Banking and Trust (BB&T), who already served as Vice President of the REDC Board, was crucial in bringing NCBA on board. NCBA leadership agreed to support the concept if the state's three largest super-regional banks would participate.

The heads of the three super-regional banks then met with the BB&T President, the NCBA head, and REDC staff. They agreed to invest on an asset-based formula, with three provisos. First, any bank capital raised would be matched by non-bank capital from private investors—for example, S&Ls, utility companies or other corporations. Second, the state would match private sector investments dollar-for-dollar up to $20 million. Finally, the state would not control NCEC operations. Indeed, the proposal stipulated that the state would own non-voting, preferred stock.

BB&T leaders and REDC staff were invited to make a presentation to the annual meeting of NCBA, which primarily represents small and mid-sized banks. The brief discussion was highly positive, with several experienced rural lenders in the audience endorsing the need for a financing entity of this type. The advisory committee had suggested that each bank's investment might be proportional to its asset size, and Association members agreed to buy into the Corporation. In the end, only $10 million of private capital was invested in start-up of the Enterprise Corporation, with the banks providing half.

With this commitment from the banking community, the next step involved discussions with the State Treasurer to confirm the state's willingness to participate and to work out the terms for the state's investment. While the Treasurer's representative to the advisory committee had been generally supportive of the Enterprise Corporation concept, the Treasurer had not yet given a clear indication of whether he would support the public matching capital and tax credits to induce private sector investment. After a series of meetings, he agreed to support the enabling legislation, if REDC obtained firm commitments from the big three banks to participate.

Believing that it had all the necessary parties on board,

REDC scheduled a press conference in mid-May to announce creation of the Enterprise Corporation. Several days before the press conference, however, the Treasurer informed REDC staff that the state should be treated as any other investor—that is, it should purchase voting common stock in the Corporation rather than non-voting preferred stock. This request contravened one of the agreements with the big three banks. REDC staff gave the banks a brief period in which to object to the request, and then proceeded with the change. The Treasurer would now have the right to appoint three members of the thirteen-person Board of the private for-profit corporation—one as stockholder and two representing the public.

Obtaining passage of the necessary legislation to create the Enterprise Corporation was relatively easy after the complicated negotiations among the various private and public investors. The existence of the capital markets analysis documenting important rural capital gaps gave the proposal considerable credibility. Moreover, the bill's proponents effectively used a number of the anecdotes from the study to marshal support from rural legislators, to whom the stories of difficulty in obtaining start-up and expansion capital rang true. A third factor was the broad-based support for the concept that had resulted from the study process itself.

Finally, the political climate was favorable for new development finance initiatives. The Lieutenant Governor, who had been a key proponent of REDC's creation and also led the Senate, was in the midst of a gubernatorial campaign against the incumbent. The Enterprise Corporation was consistent with his proposed "growth-from-within" economic development strategy, a centerpiece of his campaign platform. In contrast, the Governor relied on smokestack-chasing industrial recruitment programs. Also attractive was the ability to induce significant private sector participation through a tax credit measure that was already substantially in place, thereby reducing the amount of direct new appropriations required. The legislative leadership agreed to support separate bills appropriating $2 million in loan capital for the non-traditional lending programs of the Self-Help development bank and

$500,000 for a pilot rural microenterprise loan program. The attachment of an unrelated local finance rider amendment that had a close deadline for passage permitted the legislative leadership to fight off attempts to revise the Enterprise Corporation bill.

Two contentious political issues arose in the course of the legislative process. The first concerned the definition of "rural." Urban legislators wanted to know whether businesses located in rural portions of urban counties would be eligible for the Corporation's investments. In the end, the six counties containing the largest cities were excluded, leaving 94 eligible counties. This compromise ensured a wider buy-in, although it significantly diluted the targeting of the Corporation's investments.

The second issue concerned means to ensure that the capital needs of minority firms received adequate attention. Key participants had balked at an initial request that the Enterprise Corporation bill require set-aside provisions for minority businesses. Instead, a new bill was drafted that matched the $2 million in capital for Self-Help with $2 million in capital and operating support for existing minority-controlled economic development institutions. These funds supported development lending and technical assistance programs of minority credit unions, community development corporations, and the Institute of Minority Economic Development.

The Enterprise Corporation bill passed in July 1988, in time for the deadline on the local finance rider. On the last day of the session, the final piece of the package of appropriations for minority economic development, microenterprise financing and the Self-Help development bank was approved. REDC was called upon to administer the minority economic development and microenterprise initiatives, as well as to staff the start-up of the Enterprise Corporation. It took ten months to secure all the NCEC investments and close the stock offering; to date, three investments have been made. The microenterprise program began lending after a year of design work.

In a relatively short period of time, North Carolina put in place a development finance system to address a number of rural capital gaps. The State's role has ranged from active investor, as a voting stockholder in the Enterprise

Corporation, to a more passive provider of loan capital through existing intermediaries: the Self-Help development bank, the minority credit unions and the REDC (for creation of the microenterprise fund).

What lessons does this case yield about political marketing of development finance initiatives? First, the rural capital markets analysis was instrumental in both documenting the need and building a consensus among key parties. Potential opponents were able to participate and buy into the report's recommendations. Second, a powerful figure, in this case the Lieutenant Governor, was willing to champion the measures. Third, the proponents were pragmatic and willing to compromise on key aspects of the program design and the political process.

Some of these compromises may, however, reduce the measure's benefits to rural economic development. The fact that 94 of North Carolina's 100 counties are eligible for NCEC investments dilutes its intended focus on rural firms without ready access to urban capital markets. NCEC's public-private partnership structure, while permitting considerable leverage and access to private sector expertise, may have its costs as well. The appointment of stockholders (including those in the two public seats) who do not necessarily share the advisory committee's vision of balancing profitability and rural development underscores the difficulty of keeping a private corporation accountable to public economic development objectives. In some cases further accountability mechanisms such as requiring oversight by a public body or periodic reports on development impacts may be desirable. In spite of these limitations, North Carolina has taken on the role of investor, both active and passive, to implement a successful range of development finance activities that may serve as models for other states.

Chapter 6. Conclusions

Recurrent Themes in Development Finance

The discussion here presents a hierarchy of state development finance programs, from the state as catalyst to encourage more private sector financing down to the state as direct provider of capital to fill specific gaps. An effective finance program will proceed down the hierarchy, initially creating programs to correct market failure and induce private markets to meet development finance needs. As credit needs remain, the state can become more active, investing in new or established institutions that provide capital and meet economic development objectives. Finally, as a last resort to address stubborn but important capital gaps, the state may become a direct provider. The state's success here will depend on aiming programs at narrowly defined capital gaps and adopting innovations in management and design.

An effective finance program will proceed down the hierarchy

Development finance is characterized by experimentation and innovation. Because of the risks involved, program evaluation becomes critical. The program objectives and their relationship to overall state economic development policy must be clearly defined from the beginning, for it is these objectives to create public benefits and not simply financial considerations that distinguish public development finance from most private investment. It is also important to evaluate program objectives in light of changes in the state's economy. The development finance organization must be flexible enough to alter objectives as circumstances dictate and to adjust programs to meet new objectives.

The need for flexibility extends to the financing options as well. Development finance needs are cyclical, depending on state economic conditions. Public and private capital gaps are prone to change. Development finance programs must be able to respond, abandoning ineffective approaches while experimenting with

promising new ones. For example, subsidies that sometimes accompany development finance may need to vary as economic conditions and interest rates change. During a period of economic downturn or enhanced regulatory scrutiny, conventional financiers may become more conservative so that the size of businesses falling into the capital gap may increase. Development finance programs should also be able to respond to **expanded** capital gaps.

The most effective programs provide both financial and business development assistance

The most effective programs address both the demand- and supply-side capital gaps by providing both financial and business development assistance. For a state program to be effective, the technical and business development needs of borrowers must be addressed at the same time that alternative sources of capital are identified. Otherwise, the potential for losses that damage the integrity of the program and reduce its developmental impact is too high.

The key issue which state programs must address is increasing the **availability of capital** to target populations who lack access. Contrary to widespread opinion, the issue is not the cost of capital, since in most cases capital represents a relatively small portion of business expenses. When interest subsidies are included in development finance, the danger of substituting for private finance is high, but the developmental impact is likely to be small, since subsidies will most likely benefit firms that already qualify for market-rate capital. Still left out will be the small businesses concerned with gaining access to credit markets at any cost.

Finally, the new wave of state development finance requires a new approach to program management. Managers must be committed to the economic development objectives of the program and have the skills to make the finance programs effective. These skills must be great enough to distinguish among alternative small business investment opportunities, weighing social and private returns against the cost and risk involved with the investment. To sustain a development finance program, managers must be concerned with getting investment

returns and minimizing loan losses. However, to meet the program's economic development objectives, managers must be willing to accept lower returns and higher losses in exchange for positive social benefits.

Maintaining this balance is a key task for any development finance program manager. Particularly when the state takes on the investor role, managers must be held accountable for achieving economic development objectives. Ensuring accountability is easier if the development finance objectives are clearly stated in relation to economic development objectives, and if monitoring and evaluation are designed into the program from the beginning. When these steps are not possible, periodic review of program performance is important to determine how well economic development and financial objectives are being achieved and to modify the program accordingly.

Where Do You Go From Here?

The information presented here should enrich understanding of the rationale for development finance programs and the steps required to establish them. Most importantly, this text should provide a sense of which programs across the country represent **best practices** in development finance—those innovative, cutting-edge programs that may be worthy of further study. Each state has a unique set of capital needs and economic development goals. Some programs described here may seem inappropriate, while others will appear to be the perfect match. Acquiring more information about these programs can only help to clarify their applicability to any given state. The best insight can be gained directly from the people who manage, use and evaluate the programs described here. To help readers gain additional information, a list of programs and contact people is provided beginning on page 85. Use this information to learn more before proceeding with efforts to establish an innovative development program in your state.

Endnotes

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NC Microenterprise Fund	Bill Bynum, Program Director	919/821-1154
NY Community Reinvestment Act	Walter O'Meara, Consumer Services, NY Banking Department	212/618-6408

State Development Finance Programs

	STATE ROLE:			
Program	**Regulator/Inducer**	**Investor**	**Direct Provider**	**Key Feature**
CA Loan Guarantee Program	Inducer			Decentralized loan decision-making; banks bear only small part of risk; minimal appropriation required
CEI's Day Care RLP		Passive		State funds used to leverage public and private funds; working through private nonprofit; TA important
Center for Community Self Help		Passive		Provides capital and TA; targeted on low-income, minorities; recognized as statewide development bank
Entrepreneurial Portfolios	Regulator			Works through private sector to expand risk taking
IL Small Business Loan Program			Debt	Program flexibility key to responding to capital gaps; used loan repayments to create RLF to ensure continuity after state appropriations stopped
MA Capital Resource Company	Inducer			Private sector induced to fill high-technology capital market niche by trading investment for tax break
MA Community Development Finance Corporation			Debt/equity	Management problems in beginning; works through private nonprofits; size of loan not suited for many small businesses
MA Linked Deposit Program	Inducer			Establishes development loan categories; future public deposits depend on performance
MA Technology Development Corporation			Equity	Provides equity capital to small firms in early stage of commercializing products; focused on high tech firms

Program	STATE ROLE: Regulator/Inducer	Investor	Direct Provider	Key Feature
ME Net New Funds	Regulator			Ties interstate bank expansion to creation of new capital; no explicit development lending criteria
MI BIDCOs		Active		New institutions to fill capital gaps with debt and equity-like investments; leveraging state funds key
MI Capital Access Program	Inducer			Expands risk-taking of private sector; leveraging key; banks bear large share of risk; demand-driven
MI Northern Economic Initiatives Center			Tech Asst.	Focused on small businesses; heavy emphasis on TA; university partnership key
MN Community Reinvestment Fund	Regulator	Passive		Recapitalizes private nonprofit community lenders; public money used for reserves and operating expenses
MN Interstate Banking	Regulator			Ties interstate expansion to specific development lending criteria; targeted at critical capital gaps
National Development Center			Tech Asst.	Work with cities/states to increase effective use of existing programs; increase capacity for packaging deals
NC Microenterprise Fund		Active		Identified capital need through state audit; monitoring key; working through private sector; TA important
NY Community Reinvestment Act	Regulator			Disclosure of CRA ratings creates pressure for community lending
Southern Development Bancorporation		Passive		Provides capital and TA; targeted to multi-county, low-income area; state support in creation key

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