Accessing Capital for Rural Economic Development

Comments to the Oklahoma Rural Task Force to Access Capital and Financing for Business Development
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Jonathan Watts Hull, Senior Policy Analyst
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The Rural Lens

It is important that as people concerned with the health and success of rural America, we look at activities and policies with a “rural lens.” This means that when any policy action is considered, its impact on rural communities and the people who live there is considered, with respect to economic development, too much of economic development is repeating what worked, which drives investment and resources to metropolitan areas and industries. Rural places are different in many ways, not the least of which is the importance to the rural economy of small businesses and microenterprise. Adding a few jobs to several existing enterprises in a rural place can have as great and impact for less investment that importing a new industry from somewhere else. Honoring the existing community asset base, and building on the advantages rural places have in many ways, will help to map the path to a more prosperous rural future.

My comments this morning will take a broad look at the capital available for rural development, with some attention paid to the role of state government in rural capital. I will focus my discussion principally on capital for entrepreneurs and rural businesses, with some discussion of programs to serve communities as well. Finally, I will share with you a handful of notable programs from around the country that stand out for their excellence in serving particular needs in their communities or for their strength in serving rural communities.

I think it will be of use to begin with what may be review for everyone, but which sets the stage for our later discussion.

With regard to economic development, there are essentially two types of capital: debt and equity. Debt is capital that an entrepreneur has to pay back. Equity is capital that an investor gives up to become a part owner in the company.

Of the two types of capital, debt is the most familiar and most common. Debt involves everything from conventional loans from commercial banks, small business administration loans, loans from USDA rural development and Cooperative Business Service, as well as state, local and private revolving loan funds. While most businesses use debt capital for start up and expansion costs, rural businesses are particularly dependent on debt financing. Debt financing is relatively easily understood and is more or less straightforward, making it a comfortable fit for a wide range of people.

Debt has its limitations, however. Bank consolidation has reduced the number of banks competing for borrowers and the number of outlets for debt financing in rural communities. The
expansion of banking services offered has increased competition for deposits, which in turn limits the funds available for a bank to lend. Furthermore, banks are sensibly conservative when it comes to risk. While being risk averse is a good thing from a bank management and survival perspective, in rural areas, it can mean that unfamiliar, new, or risky new businesses cannot get the capital they need to begin operation.

A very specific, and important, type of debt financing that is growing in rural America is microcredit, or microenterprise loans. Microenterprise represents a huge amount of economic activity in rural areas. In Oklahoma, microenterprise account for 18.8 percent of all employment, with about 275,000 microenterprises in operation. These very small businesses operate in every corner of the state and contribute vastly to their local economies. They have capital needs that are often very different from other businesses, even small businesses. For a variety of reasons, these entrepreneurs are often unable to access even the small amounts of capital they require for start-up or expansion. Among these are their lack of credit history, insufficient equity, limited business experience or simply the small size of the loan. To fill this need, microenterprise loan programs extend small amounts of capital (possibly as little as $500, and usually limited to $15,000 to $25,000) and bundle together business and management training to improve the chances of the borrowers’ success.

**Equity financing**—investment capital for businesses—is less available in rural areas than in metropolitan places. Equity capital offers several advantages over debt capital for rural businesses and entrepreneurs. Primary among these is the sharing of risk over a greater number of people or entities. A secondary advantage is the involvement of experienced managers in the process, which transfers valuable skills and experience to rural businesses. Since most investors prefer to have a voice in company operations and activities, equity financing also broadens the advice available to and guidance for rural businesses.

Equity financing also provides capital for new ventures that serve to diversify the economic base of an area, since these higher risk businesses often have greater difficulty securing loans. Diversifying the economic base in rural America is a big part of the game plan, of course, but the lack of equity makes accomplishing this task much more difficult. Access to this risk capital is unorganized and difficult for rural entrepreneurs to accomplish—to such an extent that rural America is largely locked out of the bulk of private investment capital available.

While debt financing is the most commonly used path to access capital for rural development, equity financing deserves perhaps more attention. Metropolitan entrepreneurs, businesses and industries enjoy access to a wide range of investment capital, with roughly 90 percent of all equity investments going to metropolitan areas.

There are a handful of sources for risk capital for rural economic development. Rural venture capital funds are one. They operate like other venture capital firms, pooling investment capital from a host of sources and reviewing business plans for solid investments. Rural venture capital is very limited, but has become the focus of much interest in recent years. The private market for venture capital in rural areas is almost non-existent for reasons I will discuss later. The Rural venture capital funds that do exist are often coordinated by community development financial institutions—community development banks and the like—that take a double bottom line approach to business.

Many states operate venture capital firms for economic development in general. Oklahoma's Capital Investment Board is a model program of a successful state initiated venture capital fund. Because these institutions lack a specific rural mandate, they do relatively little of their work in rural America.
Rural cooperatives are another source of equity financing. They have been investing local capital in projects in rural areas for generations. Value-added agriculture projects and marketing of ag products have long been a staple of these institutions. Recently, rural electric cooperatives, which have a ready surplus of capital, have made some tentative investments in new ventures in their areas, usually tied to new industry and economic development. There are a cautionary tales in how far rural cooperatives can go to promote economic development, however, in both the Farmland Co-op meltdown of a few years ago, which is often blamed on the Co-op becoming overextended, and in the current rush among cooperatives in the Upper Midwest especially to get involved in ethanol. Given the uncertain nature of the ethanol industry, it concerns me that so much of the risk is being borne by producers.

Another important category of equity investors are known as angels, generally wealthy individuals who are local to the entrepreneur or investments that they make. They may make smaller investments than venture capital firms might choose to make, but are more likely to support early-stage companies and are willing to commit more of their own time and expertise and are more patient than conventional venture capital companies. Some efforts have been made to bring these investors together through Angel networks which help to put wealthy individuals with money to invest in touch with entrepreneurs with capital needs.

Small Business Investment Companies are SBA-licensed funds which can borrow federal money to mix with private funds. They tend to tilt toward moderate risk investments in nearby areas and are not well-represented in rural areas. The SBIC model has been adapted to encourage activity in rural areas through the Rural Business Investment Companies Program and the New Market Venture Capital Program. The Rural Business Investment Company Program has not been funded, however, and the New Market program has only seven companies enrolled, four of which are in rural areas. It is unlikely that this program will be expanded. This being said, the model is certainly there to build on for rural specific programs.

Philanthropies and foundations can be very involved in the financial profile of rural communities, although they are often not comprehensive in their focus, national in their reach, and can fulfill only part of the need. Foundations have demonstrated numerous innovative strategies that have become extremely useful to states, including the pairing of economic and social development activities and the use of broad community coalitions to build local assets. State leaders can be very influential in cultivating philanthropic support for rural development activities, particularly as a number of large foundations begin to engage policy handles related to their areas of interest.

The government plays an important role in capital markets. These include serving as a source of capital, the regulation of capital markets, and providing support services to banks and borrowers, among others.

The government provides capital in a variety of ways. The government can act as a direct lender through a wide range of programs, including those for infrastructure, housing and industrial development, as well as Community Development Block Grants, and a considerable amount of USDA rural development funding and farm service agency money. Governments at all levels can also provide loan guarantees through a range of mechanisms. While not capital per se, loan guarantees take the risk out of financing for all banks, while helping the private sector serve rural businesses. Because the loan guarantee reduces the amount of capital lenders are required to hold on outstanding loans, these programs increase their liquidity, which is a major issue for rural banks. The principal federal loan guarantee programs
are the Farm Service Agency, the Rural Housing Service, the SBA’s small business loan
guarantees and the rural business cooperative service. Housing remains the biggest part of
federal loan guarantees.

State and some local government offices offer credit subsidies (especially for housing) as well
as linked-deposit programs, and interest rate subsidies to make capital more affordable for
targeted populations or activities.

Government plays some role in providing venture capital, particularly through either seed
capital for venture firms with special missions, extending support to business incubators,
guaranteeing venture funds with state tax credits and investments of state resources, such as state
pension funds, in capital funds.

While it may seem too obvious to mention, the role of state and federal government in
regulating capital is extremely relevant. State and federal securities regulations and rules guide
the application of capital to identified needs. Federal deregulation of the banking industry in the
1990s led to interstate bank branching and increased bank consolidation, a trend that is
continues. The rules and regulations guiding particular financial instruments and financial
institutions can have dramatic impact on the availability of credit and capital for economic
development and their geographic distribution.

States can often get involved in financial markets through support services to banks and
borrowers. These include state programs on financial education, credit awareness and, recently,
identity theft. The extent to which these improve financial literacy increases a communities
ability to use capital to build assets. Rural communities in general experience lower degrees of
financial and economic literacy. Credit-counseling services for low-income borrowers are an
example of state activity on the consumer end of this category of support.

The question arises as to why it is so hard for rural places to access capital for economic
development. While the underlying reasons are far from simple, a few facts are well-known.
First among these is that, compared to metropolitan areas, rural businesses and entrepreneurs
have a smaller menu of financial products and often pay more to access capital. Furthermore,
given the array of options, it is unsurprising that there is some confusion about eligibility,
performance standards, requirements and the like. This is equally true whether it is a rural
entrepreneur or business or a rural community.

Adding to this is increased difficulty in locating the source of some of the less well established
programs. There are many options for capital, particularly loans, from state and federal sources,
but rural entrepreneurs and communities are often ill-equipped to identify and access these in a
timely fashion. Communities may also find the application and reporting requirements for this
capital difficult to manage without outside support.

Another thing that rural communities and their entrepreneurs face is competition with
metropolitan areas for capital. Metropolitan areas are where the banks have their main offices,
it is where the assets are, and it is increasingly where political clout is to be found. Rural areas
also have fewer sources of capital competing for their business, which translates into higher
costs, lower availability and fewer options. Program rules for some economic development
programs available through state and federal governments provide place-based entitlements for
larger population centers, but offer only competitive grant programs for rural places.

Since venture capital is so vital to building economies regardless of location, it is exceptionally
 vexing that equity investors shy away from rural places. This is, however, not perhaps too
surprising. For venture capitalists, rural areas have several disadvantages. Because of rural
entrepreneurs are so spread out, venture firms complain that it requires too much travel and time required to identify suitable rural investments. This lack of density makes it hard to create sufficient “deal flow” as well. Often, rural startups or expanding businesses require too much operational assistance from venture capital firms. Rural America also abounds in the “wrong” industries for venture capital, which prefers to flow to new technologies and new industries with high rates of return. Venture firms prefer 10 year cycles with expected returns of up to 30 percent. While a high-tech future may be in the cards for some of rural America, the abundance of natural resources in rural places points to a future that capitalizes on this advantage. Unfortunately, venture capital for natural resources-based industries is very slim. Rural firms and entrepreneurs, especially those requiring significant levels of operational assistance, are unlikely to return at such high rates and short cycles.

**So what does rural America need to get better access to capital for economic development?**

In short, we need to make sure that rural communities, entrepreneurs, and businesses have a full set of tools that is the right size for their needs, a full set of skills, and a level playing field.

**State government and policymakers play a major role in getting this done.**

A few of the ways states can be involved include providing capital; directing private and public capital toward rural markets; leveraging federal funds; coordinating and facilitating private and foundation investment; building social and human capital in rural places; providing oversight and ensuring accountability; improving bank liquidity; encouraging cluster development so rural entrepreneurs don't have to go it alone; and coordinating and identifying resources and opportunities. Perhaps most important of all of these it the state's role and responsibility to coordinate rural policy and activity. States typically make large investments of scarce resources in rural communities, and it makes good sense to make sure that these investments are connected to economic development goals.

**Provide capital**

State capital, loan guarantees and interest rate subsidies are very important components of rural infrastructure in particular. States also play an important role in supplying capital, often on very favorable terms, to CDCs who are then able to extend credit in their communities. As state's have sought to insulate themselves from risks associated with loan guarantees and direct and indirect lending, they have shifted to providing seed capital for revolving loan funds and venture capital entities have grown, as has the use of tax-exempt bond programs to build capital for specific purposes (mostly to expand housing, mortgage, and industrial development) and linked-deposit programs (such as the Oklahoma Rural and Affordable Housing Linked Deposit Program).

**Direct private and public capital to rural markets**

Rural markets are not particularly attractive to equity investors. Venture Capital firms seek high returns on investments and have limited investment periods (30 percent and 10 years, typically). Rural areas abound in opportunities for investment that won’t return at that rate and may need more patient investors. Venture Capital Markets are in a marketplace where the slower growth industries are neglected without help from outside, such as state guarantees of capital and management assistance for rural ventures, linkages of public investment and venture capital and the like.

State pensions and retirement funds are a source of potential investment capital for...
rural America. Arkansas has directed its state pension plans to invest in state enterprises. Institutional investors—both public and private—should be encouraged to invest in rural businesses, but will need help in identifying local opportunities.

Tax credits, loan guarantees, linked-deposit programs, gap financing and other state vehicles for directing debt capital to target populations can be coordinated and consolidated to ensure that rural communities know about and can access them easily. Coordination at the state level through a rural ombudsman provides a one-stop shop through which resources and training opportunities can be identified and directed to where the help is needed.

Leverage federal funds

Coordinate/facilitate private and foundation investment

Philanthropic investors play a major role in several states community development financial institutions. The state is very well placed to court these organizations and connecting local institutions with state, regional or national philanthropic organizations.

Build social and human capacity in rural places

Capital flows to people and places where the human and social capital is greatest. This can mean anything from increasing the percentage of rural residents with college education to improving the business, accounting, and marketing skills of rural entrepreneurs. Social capacity—the sum of the abilities, skills capabilities of the institutions and networks in a community—help to build and retain assets within a community. While these networks are often considered organic, the state can play an important role in bringing groups and individuals together and to facilitate the exchange of information across informal networks to create a web of support for rural communities.

Technical assistance enhances the credit-worthiness of the entrepreneur or business by increasing the likelihood that a loan or extension of credit will be repaid. Because these programs tend to improve the qualifications for recipients for credit, they help to extend capital into typically underserved populations and to expand business successes in rural areas. Technical assistance and operating assistance is offered through a variety of programs and is often mandated for participants in microenterprise loan programs. Federal and state programs often offer technical or operating assistance as a component of credit as well.

Provide oversight and ensure accountability

Economic development activities often benefit from an outside perspective on activities and challenges. State government, and particularly the Legislature, has a role to play in setting objectives, guiding assistance, and ensuring transparency and accountability. The states with the most successful rural development programs are often characterized by a public, vocal and demonstrated commitment to addressing rural needs by state leaders.

Improve bank liquidity
Rural banks, for a variety of reasons, operate in a tight credit market. As rural lenders have become more important as sources of credit for rural businesses, money for loans has become less easily available. Remedies for this at the federal level, including access to Farm Credit System and Federal Home Loan Bank monies, require complex legislative fixes that are unlikely to come to pass. The FDIC’s rewrite of the Community Reinvestment Act rules, which was intended at least in part to remove some of the regulatory burdens on small banks, would possibly increase liquidity among rural banks, but at the expense of credit available to underserved populations.

Secondary markets for banks is another option that is very underutilized in rural America. Loan poolers or remarketers just do not operate in rural areas, generally, which means that very few rural banks can take advantage of the secondary market that exists for metropolitan banks. This is complicated by high transaction costs and information costs for rural banks. These hurdles can be overcome, but will require state and federal action to increase debt remarketing activity.

Encourage cluster development

Cluster development has become the most commonly pursued economic development strategy. Cluster development in rural places requires new thinking about what rural places have to offer and can feasibly do. We’ve gotten to the point in economic development that success means to bring in something new and not adding to what is in place. The skills of that the community already has should be the starting point in building economic development in order to honor what the community already has.

Coordinate and Identify

Rural communities are at a disadvantage in identifying, accessing and managing funding from a variety of sources—state, federal, private and philanthropic. States with coordinated networks for rural EDCs or central rural offices/centers that serve rural communities are better linked and more capable of connecting communities with opportunities.

With that as a backdrop, I'd like to turn now to specific programs in place, I have selected a handful of notable programs from outside of Oklahoma. These represent a mix of state and private programs which serve as models for various approaches to rural development.

Kentucky Highland Investment Corporation and the Southern Appalachian Fund (really strong technical assistance component);

Shorebank (Illinois) (comprehensive community development model; commercial real estate development)

Southern Development Bank (Arkansas, Mississippi, Louisiana)

One Georgia (tobacco funds, shifted from comprehensive model to one that supports communities)

North Carolina Rural Center - Microenterprise Loan Program
and Capital Access Program/Business Loan Program (provides a loan loss reserve to allow banks to make high-risk loans)

West Central Initiative (Minnesota) focuses on community and family support and workforce development; comprehensive approach; builds human and social capital

Rural Capital Advance (Federal Home Loan Bank of Des Moines) operates in much the same way as the NC program, but demonstrates this approach finding traction at a regional level.

Coastal Enterprises Inc. (Maine) CDFI—makes loans and investments; natural resource based investments and affordable housing; links development finance to building human and social capital

Economic Development Institute (Georgia) provides training and assistance to communities to help them support their local entrepreneurs

Office of Rural Community Affairs (Texas) comprehensive rural agency; direct state and federal resources and help to identify other sources of funding or capital. ORCA demonstrates excellent coordination of resources and serves as a “one-stop shop” for rural Texas and Texans.

Two other important resources:

Rural Policy Research Institute Center for Entrepreneurship

Regional Economic Development Research Laboratory, Clemson University—Dr. David Barkley