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# 1 Capital Availability and Economic Development

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## The Growing Field of Economic Development Finance

In recent decades, finance has emerged as a large and increasingly complex field within American economic development practice. State governments were early innovators in development finance, creating new programs in the 1980s to help restructure their economies.<sup>1</sup> Many local governments used federal grants to create revolving funds to advance their economic development agendas, while applying their taxing and bonding powers to facilitate new development projects or revitalize downtown districts. Grassroots community organizations built their unique brand of economic development finance with nonprofit loan funds and community development credit unions that raise capital from socially oriented investors. Meanwhile, banks and other private financial institutions expanded partnerships with government and community-based organizations to better address economic development needs. While there is no census of economic development finance programs, several thousand exist across state and local governments, the nonprofit sector, and for-profit financial institutions. As their numbers grow, these programs are expanding their organizational diversity and employing new finance tools.

The prominence of finance programs in economic development strategies is evident among the Empowerment Zones (EZ) and Enterprise Communities (EC) designated by the U.S. Department of Housing and Urban Development (HUD) in 1994 (Hebert et al., 2001). Sixteen of eighteen sites studied in HUD's 5-year evaluation established programs to improve access to capital as part of their job creation and business development initiatives.<sup>2</sup>

With the expansion of economic development finance programs, a growing need exists for skilled professionals to staff and manage these programs. Economic development finance practitioners require specialized knowledge and skills that cut across several fields. In addition to analyzing financial statements and understanding how firms and development projects are financed, they need to comprehend key areas of public policy and how

municipal finance relates to economic development. A solid grounding in how capital markets operate must be combined with knowledge on how to link finance programs to broader economic and community development goals. Development finance practitioners also need diverse management skills that encompass market analysis and program design, overseeing investment transactions, building partnerships to advance development outcomes, managing assets, and raising new capital.

Practitioners who do not manage finance programs also are affected by the growing innovation and diversity in the development finance field. They need to understand which program models and finance tools are best suited to their economic development goals and capital markets. Over a dozen program models exist to expand capital availability. Consequently, it no longer suffices for local professionals to select a federal grant source and set up a revolving loan fund. Instead, they must know which models will advance their goals, how to attract private funding to their program and projects, and how to fit programs and tools together into a comprehensive development finance tool kit. While each community differs, practitioners can benefit from the lessons and experience of the many existing finance programs to effectively adapt program models to their situation. Furthermore, existing programs within a region and the tools available under federal and state laws are assets that economic developers can deploy to enhance their effectiveness. With a deeper understanding of business and project finance, available finance tools, and the capabilities of different finance models, practitioners will be better equipped to help finance growing firms, implement projects, and build stronger collaborations between finance programs and other services.

## The Purpose and Design of This Book

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The bottom line is that all economic development practitioners need to be well versed in the basics of development finance and the state-of-the-art application of program models, policies, and tools. *Economic Development Finance* is written to provide a comprehensive treatment of the field geared to both students studying the subject for the first time and practitioners seeking to expand and update their knowledge. Scholars will also benefit from the extensive information on economic development practice collected in this volume. It covers the technical skills needed by professionals who oversee transactions and manage programs and surveys the current breadth of economic development practice in the United States, covering key concepts, tools, and program models. To address practitioner, student, and academic needs, this book covers the following topics:

- Foundation skills in accounting, business, and real estate finance, and financial statement analysis (Chapters 2 through 7)
- Policies to expand capital availability by private financial institutions (Chapters 8 and 9)

- Program and institutional models for economic development finance (Chapters 10 through 13)
- Federal and municipal economic development programs and tools (Chapters 14 and 15)
- Management of development finance institutions (Chapters 16 through 18)

## The Role of Finance in the Economic Development Process

Before delving into the technical aspects of economic development finance, a working definition of economic development is needed along with an understanding of how finance contributes to the economic development process. Economic development is often viewed as the process of generating new jobs and economic activity within a defined area. However, there are two limitations to this definition. First, the outcome of economic development transcends jobs, income, and wealth. It includes an area's quality of life. Although less tangible than jobs or income, quality-of-life goals are part of many economic development strategies. Examples include a safe and healthy environment, access to rewarding leisure activities, and opportunities for community celebration and civic engagement. Postwar economic revitalization in Pittsburgh demonstrates the role of quality-of-life issues in economic development. One of the city's priorities was reducing air pollution and implementing comprehensive air pollution control as a first step in making the city attractive for new investment.<sup>3</sup> Second, economic development is a process that must be sustained over time for regions to reproduce positive economic and social results. Albert Shapero makes this point when discussing Jane Jacobs's comparison of Birmingham and Manchester, England. Birmingham remained a dynamic city into the mid-twentieth century not because of static economic results but rather due to its successful adaptation to new economic conditions.<sup>4</sup> Thus, the economic development process creates assets that enable a region to sustain and recreate its desired economic and community outcomes over time. Incorporating these two broader considerations, our definition of economic development is

*A process of creating and utilizing physical, human, financial, and social assets to generate improved and broadly shared economic well-being and quality of life for a community or region.*

Within this definition, finance has two explicit roles. First, it is one input into the process that generates the desired outcomes of jobs, income, and quality of life. As one input into this process, it is a necessary but insufficient factor for successful economic activity. Businesses, the primary units of economic activity, require many conditions and inputs to be viable:

- A market for their goods and services
- Transportation access to get their goods or services to customers and receive inputs

- Information and technology to efficiently design, produce, deliver, and service products
- Labor and its embedded skills for production, administration, management, and service aspects of the business
- Management and entrepreneurial capacity to design and coordinate the process
- Materials and energy used in production
- Facilities and equipment needed to operate all aspects of the business
- Financial capital to purchase these inputs and bridge the time gap between when cash is spent and revenue is received

This list shows that financing is not only one of many factors in an enterprise, but it comes relatively late in the business development process. In other words, financing becomes a constraint to business formation and growth when the other production factors are in place but appropriate financial capital is not available.<sup>5</sup> Nonetheless, when financial capital is not available to firms or projects that can use it productively, economic activity slows as new firms are not started, existing firms postpone investments, and existing enterprises contract or fail. Sustained capital availability problems, as redlined urban neighborhoods have experienced, can undermine an area's desirability and well-being as businesses fail and leave, the housing stock deteriorates, and community infrastructure and facilities are not maintained and upgraded.

A second implication of this list is that capital availability not only concerns the funding of enterprises, it also affects the quality and supply of other inputs into the economic development process. Since businesses are the primary generators of economic activity, economic development finance practice focuses on the direct financing of firms. However, regions also need to finance the infrastructure that supports business activity, the land and real estate facilities to house firms, and the education and training for a highly productive and innovative workforce. Consequently, this book addresses tools and programs used in real estate and infrastructure finance. These two areas overlap with business finance in economic development practice since several tools and programs that finance firms can be applied to real estate and infrastructure projects. The basics of real estate finance and its capital availability issues are covered in Chapter 7; later chapters on tools and program models address their application to both real estate projects and businesses. Chapter 15 covers municipal finance—the primary means for funding infrastructure projects.

Beyond funding specific enterprises and projects, economic development finance concerns the creation of institutional capacity to ensure sustained capital availability for communitywide economic development needs. This challenge transcends the use of specific tools and programs to encompass broader issues of practice, program design, and management. It requires a view of practice that embraces building bridges and active collaboration with

private financial institutions, ongoing program innovation and adaptation, and identifying new investment sources to meet evolving regional capital needs. The treatment of program management in Chapters 16 to 18 also incorporates this view of economic development finance as regional asset and institutional capacity-building.

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## Capital Availability and Capital Market Imperfections

Economic development finance practice is inherently intertwined with the operation of private capital markets. In simple terms, development finance interventions fill private capital market gaps; their goal is to ensure capital availability when private financial markets fail to supply capital to firms and projects that can productively use it. *This conception of economic development practice is reflected in the two-part theory of development finance intervention elaborated in this chapter. The first form of intervention is working with private financial institutions to reduce market imperfections, eliminate regulatory barriers, and remove other obstacles that prevent private markets from supplying development capital. The second type of intervention is creating alternative institutions to directly supply capital to markets, projects, and firms that private institutions cannot serve due to their risk level, transaction size, social benefits, or other reasons.* When such interventions succeed in filling capital gaps, new economic activity results, as financing is provided to start, grow, or maintain a business, or to develop a real estate project, that would not otherwise receive the requisite capital. When a program delivers financing that can be secured from private markets, it *substitutes its capital* for what private market institutions will supply and no new economic activity results. As the primary pitfall of development finance, avoiding capital substitution is the practitioner's North Star to true economic development impact.

Since economic development finance is about filling private capital market gaps, sound practice requires a theory of capital market gaps: what they are, what causes them, and how to address them. The balance of this chapter is devoted to these issues. First, *capital market gap* is more fully defined. Second, the theory of competitive markets is considered to identify the conditions under which capital markets may fail to supply capital to projects or firms. Next, the structure and operation of private capital markets is examined to uncover the actual sources and occurrence of capital supply gaps. A final discussion addresses how the nature of capital market gaps shapes economic development finance practice and elaborates the two-pronged theory of intervention: (1) expanding capital availability by addressing the causes of market imperfections within private financial institutions and markets; and (2) creating new programs or institutions to fill gaps that can't be addressed through market-perfecting policies.

The theory of competitive markets argues that when competitive market conditions exist, capital is efficiently allocated to investments that offer the highest return to capital, adjusted for investment risk. Thus, a capital market gap exists when capital markets fail to allocate capital to firms and projects, or entire classes of firms or projects, that offer a rate of return equal to that offered by other investments with the same level of risk. In other words, when market imperfections exist, capital is not allocated to firms and projects that can use capital most productively. When systematic conditions in market structure or operations cause market imperfections, the resulting capital gap will be systematic, affecting an entire class of financial transactions, firms, or projects. Capital market imperfections, therefore, create supply gaps that generate a need for interventions to ensure capital availability for community economic development.

Microeconomics provides a theory of perfect competition to identify the potential sources of capital market imperfections.<sup>6</sup> The efficient allocation of capital in perfectly competitive capital markets rests on the following assumptions about the structure and operation of capital markets:

- There are many suppliers and users of capital in the market.
- Suppliers and users have perfect information about the transaction or there are no significant costs to secure such information.
- The costs to complete a transaction are insignificant relative to the size of the transaction.
- The transaction has no externalities (all costs and benefits associated with the transaction are reflected in prices).
- Participants are rational benefit maximizers who make decisions to maximize their economic returns consistent with their risk preferences.

Market imperfections occur when these underlying assumptions do not exist for actual capital markets. When there is a lack of competition and a monopoly or oligopoly exists in the supply of capital, then the suppliers of capital may set terms or allocate capital in ways that prevent firms that offer a competitive rate of return from receiving capital. A lack of information, high costs to gain information, or high transaction costs for certain firms or transactions can reduce the net return on these investments and limit capital availability. Suppliers of capital will avoid these investments, even if they use capital as productively as other firms, and instead seek out investments with more available information and lower information and transactions costs. Nonrational or benefit-maximizing investment behavior might also lead to capital market gaps. If investors are risk averse, then capital will not be available for higher-risk firms, projects, or investments, even when such investments provide a return that compensates for the higher risk. Investors who supply capital for nonrational reasons, such as discrimination, fads, or beliefs other than expected risk-adjusted returns, may oversupply capital to certain investments and prevent the flow of capital to other projects that can

use the funds more productively. A final potential source of capital market failure is the existence of externalities in which all costs or benefits associated with an investment are not reflected in private returns. In other words, the social return from an investment may be very different than the financial return earned by private investors. For example, a firm that produces a highly efficient and low-emission engine will generate social benefits from reduced air pollution, but the resulting health care and other cost savings are not captured in the engine's prices and return to investors. If the financial return to financing this firm is not competitive with similar investment alternatives, then the firm will not be supplied with capital by the private market, even if the social returns are great. For this reason, it may be socially desirable to intervene in capital markets to expand financing for firms or projects that generate significant public or social returns, even when other market imperfections do not exist.

This discussion suggests two benefits that result from addressing capital market imperfections.<sup>7</sup> First, increased economic efficiency and productivity should occur as firms that can use capital most productively are supplied funds. Second, economic development or social benefits are generated from supplying capital to firms or projects which yield desirable outcomes that private markets don't adequately value (e.g., lower unemployment or reduced pollution). These economic benefits provide a public policy rationale for economic development finance interventions and, when measurable, offer a way to test whether the returns from a specific program or policy outweigh its costs (Bartik, 1990).

## Market Imperfections and Capital Supply Gaps in Practice

While the theory of perfect competition provides insight into potential capital supply gaps, the institutional structure and operation of capital markets determines what capital market imperfections actually exist and how they influence capital availability. Capital markets are the collective set of institutions through which savings and the economy's surplus financial resources are accumulated and channeled to households, businesses, governments, and other entities that demand capital to support their consumption and investment. Capital markets have two organizational forms that operate differently with distinct consequences for market imperfections: public capital markets and private capital markets. Both are private sector markets in which the public-versus-private distinction refers to the nature of and access to information within each type of market rather than their governmental status. *Public capital markets* are characterized by extensive publicly available information on investments, standardized investment instruments, liquid investments that are easily bought and sold, and federal and state government regulation. It is the first characteristic, the large amount of publicly

disclosed information, that accounts for the label, “public” capital markets. Another aspect of public markets is that individual investors can directly purchase the financial assets sold in these markets. An individual can evaluate the range of investment options and directly purchase shares of stock in Intel Corporation or buy notes (a form of debt) of the United States government or DuPont Corporation. As indicated below, this is an important difference between private and public capital markets.

Public capital markets include the stock markets that provide equity or ownership investments in businesses, the bond markets<sup>8</sup> that supply debt financing to governments, businesses, and other entities (e.g., nonprofit organizations such as universities), and the money markets, which supply short-term debt (i.e., less than 1 year in duration) for businesses, governments, and nonprofit entities.

Three kinds of financial institutions handle transactions in these markets: investment banks, securities brokers, and securities dealers. Investment banks bring new stock and debt sales to market, either by buying the securities from a firm and then reselling them to the public (underwriting) or by locating and selling the securities directly to specific buyers (placement). Investment banks also package financial assets, such as home mortgage loans, into securities and bring these derivative securities to market. Securities brokers arrange the sale of existing securities between buyers and sellers while security dealers buy and sell securities themselves to earn a profit and to ensure the existence of an active market in which to buy and sell securities.

An important factor in assessing capital market imperfections is the process by which a firm raises capital in a public market. To raise debt or equity capital in public capital markets, a firm must undertake the following steps:

- Prepare legal documents that define the security and its terms
- Complete detailed disclosure information on the firm, the investment being offered, and its risks
- File the disclosure and offering documents with the federal Securities and Exchange Commission (SEC) and, in many cases, with state government security divisions
- Secure a credit rating (for debt securities)
- Offer and sell the securities to investors

The sale of stock or debt in a public market costs at least several hundred thousand dollars, when an investment bank is not used. An investment bank’s fee adds several hundred thousand to several million dollars, depending on the size of the security offering. According to a U.S. General Accounting Office study, the average cost for completing an initial public offering (IPO) of stock in 2000 was 14.4% of total proceeds, or \$720,000 for a \$5 million IPO, and 9.4% of total proceeds, or \$920,000 for a \$10 million IPO.<sup>9</sup>



While offering securities to the public without an investment bank reduces transaction costs, this is quite difficult to accomplish and likely to raise less capital when it is feasible. Moreover, investment banks, seeking to increase their profits, are selective about which securities they bring to market. The major investment banks prefer large offerings that generate large fees and offerings by firms that can be readily sold to investors. Many observers feel that this behavior limits access to the public equity and debt markets to offerings of at least several million dollars and limits stock IPOs to either firms with minimum annual profits of \$1 million and high growth rates or early-stage firms without profits that are in industries with very high expected growth (i.e., Internet-related or biotechnology firms) (GAO, 2000).<sup>10</sup>

Public capital markets approximate perfect competition in some ways, but other characteristics generate market imperfections. On the one hand, public markets are highly competitive with many buyers and sellers participating in the market to set fair prices, and investors have access to extensive information at little or no cost. On the other hand, the high transaction costs required to access these markets and the profit requirements of investment banks make them infeasible for most firms or projects that need less than several million dollars in capital. Moreover, investment fads and cyclical factors affect supply and can generate excess capital for some firms and industries while preventing others from raising capital in public markets. The Internet stock boom of the late 1990s exemplifies this phenomenon. Many young Internet-related firms were able to sell stock to the public even with minimal sales, no profits, and very uncertain prospects for future profitability. Extreme optimism about the “new” Internet economy generated a large supply of capital for firms in this industry, many of which quickly failed (Sohl, 2003).<sup>11</sup> As capital flowed to Internet firms, some firms in profitable industries with good growth prospects reported difficulties accessing public credit markets.<sup>12</sup> These investing patterns do not fit the expected behavior of rational benefit maximizers posited in microeconomic theory.

*Private capital markets* are organized differently and provide an alternative source of capital to firms and projects that cannot access the public markets. In private capital markets, an intermediary organization holds and manages funds for investors, with financing transactions negotiated between the intermediary and the capital user. While investors in the public markets can directly buy and sell securities, the suppliers of capital in private markets place their funds in a financial institution, which decides where to lend and invest these funds. For example, when a household deposits savings in a bank or purchases an insurance policy, it relies on the bank or insurance company’s staff to invest these funds and provide the expected return. Consequently, suppliers and users of capital are matched on the financial institution’s balance sheet, not through the direct sale and holding of securities by investors. A second aspect of private capital markets is that financing transactions are negotiated between the firm and the financial institution and are not based on publicly available information and standardized securities. The financial

institution conducts its own investigation (called due diligence) of the firm's potential to provide the expected return on investment and negotiates specific terms and conditions with the firm seeking capital.

Five primary financial institutions comprise the private capital markets:

*Commercial banks* are government chartered financial institutions with broad lending powers that have access to government deposit insurance.

*Thrift institutions* are government chartered financial institutions with more limited lending powers and access to government deposit insurance. They often focus on home mortgage and real estate lending. Savings banks and savings and loan institutions are in this category.

*Commercial finance companies* are financial institutions that are not government chartered and do not raise capital through deposits. They have more flexibility in the type of loans and investment that they can make and often provide higher-risk debt to both households and firms.

*Insurance companies* manage the financial assets and liabilities associated with insurance products. They invest premiums received from life and other insurance obligations to cover the financial obligations of their insurance policies. Life insurance companies, with long-term liabilities, are an important source of long-term financing for firms and real estate projects.

*Venture capital funds* are private investment entities that primarily supply equity to firms with the potential for very high returns.

While private financial markets are not formally organized into separate equity and debt markets, as are public markets, direct equity investments are largely made through venture capital firms. The other institutions are primarily suppliers of debt financing. Although some banks, finance companies, and insurers make their own direct equity investments, they typically invest equity through participation in venture capital funds.

In addition to these formal institutions, private capital markets include informal noninstitutional sources, such as family members, friends, and angel investors. While the size and extent of informal financing is not well documented, it is believed to be an important capital source for start-up businesses and for raising small amounts of equity. A firm's access to informal capital, however, is tied to the owner's social and professional network and the wealth of family and friends.

National banking and the growth of electronic banking have reduced geographic variations in capital availability, but competition and supply in private capital markets still depends on the type and number of private institutions serving a region. Regional differences are most evident in the venture capital industry, with investments highly concentrated in California, Massachusetts, New York, and Texas.<sup>13</sup> While this pattern reflects the

greater investment opportunities in these states, the concentration of venture capital funds and angel investors in these states is also a factor. Consequently, a firm's ability to access private equity partly depends on its location. Debt availability is widespread since there are many sources of debt and most areas have several financial institutions competing to make business loans. Nonetheless, areas with a concentrated banking market may face a monopoly or oligopoly situation that affects capital supply. Rural areas are most likely to experience this problem since they typically have fewer banks. Researchers found that limited competition in banking markets reduces the availability of moderate or higher-risk debt since financial institutions without competition earn above average profits on lower-risk lending.<sup>14</sup> Business strategy decisions among the financial intermediaries servicing a region also shape capital availability, especially in more concentrated markets. These decisions define which markets financial institutions serve, the debt products they offer, and the financing terms and criteria they employ. For example, if lenders decide that interest rate conditions make it too risky to offer fixed rate financing, then firms may be limited to variable rate debt. Similarly, some banks may decide that larger or more predictable profits will be earned by investing in the bond market compared to small business lending, which will limit the funds available for small business loans.

The process to secure financing differs in private capital markets and yields separate market imperfections from those in public markets. The process to secure financing in private capital markets involves the following steps:

- Determining the type and size of financing needed
- Identifying the specific intermediaries that provide this type of financing
- Preparing a proposal or request for financing
- Contacting the intermediary to discuss the requested financing
- Participating in the lender's due diligence process and decision-making process
- Negotiating the financing terms and legal documents
- Completing the legal documentation and loan closing to obtain funds

Note that the financial costs that firms face to complete transactions in private capital markets are much lower than for public markets. No filing, registration, or underwriting fees are needed to gain financing from a private financial intermediary. The primary transaction expenses in private capital markets are legal fees to prepare loan or investment documents, but these are far less than legal costs for an IPO or public debt sale. Consequently, monetary transaction costs are not a significant obstacle to financing in private markets. However, intermediaries in private capital market often impose other costs on firms as they seek to manage risks from more limited information and their illiquid investment via the terms of loan and investment agreements. Investment or loan agreements may add reporting costs, place limits on the firm's actions, or set financial standards that constrain its business and financial flexibility.

Information availability and costs are addressed differently in private capital markets and pose a greater obstacle to financing. In public markets, the firm seeking capital bears the responsibility for, and incurs the legal, accounting, printing, and other costs associated with preparing disclosure documents to issue securities. In private markets, on the other hand, the financial intermediary supplying capital conducts its own research and due diligence to evaluate the risks associated with potential financing transactions. While firms compile and prepare some information, the financial intermediary must verify this information, collect additional information, and adjust its financing based on its risk analysis. Unlike the public markets, where information disclosure is legally regulated and subject to both well developed standards and third party review, much critical information about a firm or project is known within the firm and opaque to the capital supplier in private markets.<sup>15</sup> Moreover, the information costs associated with making a loan or equity investment have a large fixed component that is not proportional to the loan or investment size. As bankers often comment, it costs them as much to make a small loan as a large one. These fixed information costs often make it unprofitable to extend small loans or make small equity investments. Therefore, financial institutions often do not consider business or commercial real estate loans below \$50,000 to \$100,000. Thresholds for venture capital investments are far higher with many funds unwilling to consider transactions under \$5 million.<sup>16</sup>

Government regulation also influences capital supply in private financial markets since many intermediaries, especially government insured depository institutions, are subject to government oversight and regulation. One goal of government regulation of financial institutions is ensuring the safety and soundness of depositors' funds. Regulations create financial incentives for institutions to hold less risky assets, which can lead to risk-averse lending policies among some banks. Moreover, when financial or economic conditions increase the potential for bank losses and failures, regulators may directly seek to change bank lending practices. For example, when the Massachusetts economy entered a recession in the early 1990s, bank regulators feared a repeat of the wave of bank failures that occurred in Texas and strictly examined the loan portfolios of many banks. In some cases, they placed banks under orders to cease and desist from making certain types of loans. These regulatory actions contributed to a large reduction in bank lending and a credit availability crunch. Regulators were subtler as the risk of a recession rose in the late 1990s. Concerned about liberal lending practices, the Federal Reserve Bank sent out a letter to banks in June 1998 warning them to tighten business lending standards because a recession could leave them with many bad loans.<sup>17</sup>

Finally, private financial institutions can also be subject to investment fads, nonprofit-maximizing decisions, and discriminatory biases that contribute to capital supply gaps. Venture capitalists often follow investment fads and biases in the stock markets since they depend on IPOs to earn

their investment returns. Consequently, venture capitalists had the same predilection to overinvest in Internet-related firms during the 1990s as did stock market investors. Banks and private market intermediaries also can be influenced by biases. Some lenders practice statistical discrimination in which they classify an entire group of businesses, such as restaurants or start-ups, as too risky without evaluating the merits and risk of specific transactions.<sup>18</sup> Several studies document racial disparities in home mortgage lending in several cities during the 1980s and 1990s, even after controlling for borrower credit, property condition, and market factors.<sup>19</sup>

## Implications of Market Imperfections for Economic Development Finance

As the prior section shows, the operation of capital markets does not match the assumptions underlying perfect competition but instead is characterized by market imperfections that can create capital availability gaps. Table 1 summarizes the market imperfections identified from the analysis of market structure and operations for both private and public markets. Despite the United States' well-developed capital markets, a firm's ability to secure capital is not simply a function of its capacity to provide lenders and investors a competitive rate of return. Rather, the firm's location, industry, amount and form of capital needed, and the number and type of financial institutions serving its area can all affect its access to capital. Nonetheless, some common capital supply gaps emerge from the analysis of capital market imperfections. First, equity capital in amounts below several million dollars is not available from public markets and institutional sources. Moreover, for small and early-stage firms, equity capital is largely limited to firms in "hot" industries with perceived high growth potential. Second, debt capital for small firms and in amounts below several million dollars is largely available from private financial institutions. Thus, debt availability is dependent on competition and lending policies within the local banking and commercial finance market. Small business and real estate loans below \$50,000 are not available from private financial institutions in most markets, and in some cases the threshold may be higher. Furthermore, regulatory policies, cyclical economic conditions, and limited competition all affect the cost and availability of debt.

Several implications for economic development finance practice emerge from this analysis. First, local economic and financial market conditions shape capital supply gaps. Therefore, to design effective intervention strategies, practitioners need to understand local capital market conditions, the private financial institutions active in their region, and how their business strategies and lending policies affect capital supply. The formal aspects of capital market analysis and its application to program design are discussed in Chapter 16. Since capital markets are dynamic, with conditions changing

**Table 1.1** Summary of Market Imperfections by Capital Market Type

<i>Potential Imperfection</i>	<i>Public Equity Market</i>	<i>Public Debt Market</i>	<i>Private Equity Market</i>	<i>Private Debt Market</i>
Competition (Supply side)	Extensive	Extensive	Limited, depends on location, investment, and sector	Moderate, depends on location, investment, and sector
Information Access	Extensive publicly available information provided by firms. Firms followed by analysts	Extensive publicly available information provided by firms. Credit ratings available	Must be collected and analyzed by investor; may not be feasible for small transactions	Must be collected and analyzed by lender; may not be feasible for small transactions
Transaction Costs	High costs to firm for legal, disclosure, printing, and underwriters' fees	High costs to firm for legal, disclosure, printing, and underwriters' fees	Low to moderate costs, primarily for legal work	Low to moderate costs, primarily for legal work
Rational Profit-Maximizing Behavior	Cyclical factors and fads affect investor demand; may be discrimination for or against certain industries	Cyclical factors and fads affect investor demand; may be discrimination for or against certain industries	Cyclical factors and fads affect investor demand; may be discrimination for or against certain industries	Regulations affect type of loans. Discrimination for or against certain industries, type of firms, locations, etc., may occur
Regulatory Factors	Impose high transaction costs	Impose high transaction costs	Nonregulated	Limits types and level of risk; banks are required to meet community credit needs
Conclusions	Not viable for raising small amounts of equity below several million dollars	Not viable for raising small amounts of debt below several million dollars	Hard to raise small amounts of equity. Available largely for firms with very high growth potential and capacity for IPO or acquisition	Most important capital source for small firms and development projects; limited supply of long-term debt, small loans, and riskier financing

from year to year, practitioners also gain critical knowledge through their ongoing engagement in financing transactions and dialogue with private financial institutions, firms, and industry associations. Second, development finance professionals are in the business of expanding the supply of small amounts of capital and higher-risk capital. These are the most ubiquitous capital supply gaps to address. Finally, the private capital markets are the

most important financing source for small businesses and small-scale or unconventional development projects, both of which will have little access to the public markets. Developing relationships with and designing programs that work in tandem with key private capital market institutions, especially commercial banks and venture capital firms, is central to the work of economic development finance.

## A Framework for Expanding Capital Availability

Expanding capital availability for economic development entails two types of market interventions: (1) perfecting the operation of existing capital markets and (2) creating alternative development finance institutions. The first form of intervention changes the operation of private capital market institutions either by eliminating the sources of market imperfections that create capital gaps or changing the behaviors, perceptions, and risk preferences of private financial institutions. Practitioners produce the greatest impact by changing the performance of existing capital markets since they are the primary means for financing economic activity and allocate hundreds of billions of dollars of capital. This critical area of economic development finance practice involves three interventions:

- *Risk-sharing tools and policies* that encourage private sector institutions to bear greater risks and extend higher-risk debt financing. Loan guarantees are the most common example of risk sharing. Other approaches include portfolio-based loan insurance and financial incentives. Chapter 8 focuses on these interventions.

- *Bank regulatory policies* can reduce barriers to economic development investments by financial intermediaries and create incentives and standards to expand services, lending, and investment for economic development purposes. Banks also provide an institutional platform that development finance practitioners can use to address disinvestment and capital market failure. The use of banking regulations and banking institutions to expand capital availability is the focus of Chapter 9.

- *Absorbing information and other transaction costs* for private lenders and investors by collecting and generating information, preparing financing applications, analyzing potential investments, or servicing loans. This is a crosscutting approach that is discussed under program models in Chapters 10 through 13.

Despite the importance of expanding capital availability through private sector financial markets, there are limits to the first intervention strategy. When the institutional structure of capital markets does not support the channeling of sufficient capital to regional economic development needs or when

private financial intermediaries are too risk averse, it becomes necessary to establish alternative financial institutions to ensure capital availability. New public sector, nonprofit, and community-based financial institutions can redirect the region's own savings and attract external funds to expand the supply of capital to business enterprises and development projects. Five alternative development finance institutions are covered in this book:

- *Revolving loan funds*, a common and easily adaptable finance program model that emerged from local economic development practice, are discussed in Chapter 10.
- *Venture capital* models for expanding the availability of equity and high-risk investment capital are the subject of Chapter 11.
- *Two community-based financial institutions*—community development loan funds and community development credit unions (grass roots institutions that typically serve low-income areas and populations)—are covered in Chapter 12.
- *Microenterprise funds*, a fast-growing form of U.S. development finance inspired by practices in developing countries and focused on very small enterprises and the self-employed, are addressed in Chapter 13.

These two modes of intervention, perfecting existing capital markets and creating alternative institutions, are not mutually exclusive. Economic development finance involves using both strategies, often in complementary and synergistic ways. For example, a region might create loan guarantee programs to expand bank financing for higher-risk small business debt of \$100,000 or more while also creating a new revolving loan fund or microenterprise fund to supply debt in smaller amounts. Similarly, state regulations might be altered to allow increased bank, insurance company, and pension fund investment in venture capital while new quasi-public intermediaries are created to manage this new source of private equity capital. These are only two examples of the many ways in which both intervention strategies can be combined. Each community will create its own examples based on local economic development goals and opportunities, and in accordance with its capital market environment.

As an entry point into economic development finance, this chapter has focused on the supply side of capital markets to develop the concept of capital market perfections and how it shapes intervention strategies. However, this presents an incomplete picture of financial markets, ignoring the demand side of the marketplace. Economic development finance practice also requires an understanding of the financing needs of small businesses and development projects and what forms of capital should be supplied to address these needs. Additionally, practitioners need skills to manage individual financing transactions, such as evaluating whether a business or development project can productively use capital and defining the appropriate type and terms of financing to offer.

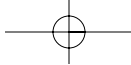


The next section addresses these demand side issues. It begins with an overview of how businesses are financed and explains the roles and language of equity and debt capital. Following this introduction, the text takes a detour in Chapters 3 and 4 to explain how businesses report financial information and how this information is used to evaluate a firm's financing needs and its capacity to productively use and repay new capital. With this foundation in place, the next three chapters provide a detailed look at the most common uses of economic development finance: business working capital, business fixed assets, and real estate development projects.

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## Endnotes

1. David Osborne (1999) discusses the role of governors and state governments in economic development finance in *Laboratories of Democracy*, especially in chapters on Massachusetts, Michigan, and Pennsylvania.
2. Hebert et al. (2001), *Interim Assessment of the Empowerment Zone and Enterprise Communities Program: A Progress Report*, pp. 5-2-5-3.
3. Frey Foundation (1993), *Taking Care of Civic Business*, p. 51.
4. Shapero (1984), pp. 12-14.
5. By implication, financing is only one part of a region's economic development strategy that must be linked to other initiatives that address the quality and supply of the other economic assets.
6. A definition of perfect competition can be found in Nicholson (2002), *Microeconomic Theory: Basic Principles and Extensions*, pp. 422-423. A discussion of "imperfect competition" when these assumptions do not hold is found on pp. 469-481.
7. Timothy Bartik (1990) provides a more complete economic development argument for addressing market imperfections that extends beyond capital markets in *The Market Failure Approach to Regional Economic Development Policy*.
8. The bond market is the primary supplier of capital for the municipal debt tools discussed in Chapter 15.
9. U.S. General Accounting Office (GAO) (2000), *Efforts to Facilitate Equity Capital Formation*, p. 24.
10. These points, and other obstacles that small businesses face in raising equity from public stock markets, are discussed in the U.S. GAO (2000) report *Efforts to Facilitate Equity Capital Formation*.
11. Sohl details a number of these failures in his 2003 article and cites a statistic from Webmergers.com that 516 Internet firms shut down during the first 11 months of 2001.
12. In my consulting work, I discovered that firms in the medical device industry, which grew faster than most manufacturing industries in the 1990s and had favorable long-term growth trends, reported far greater difficulty completing IPOs during this period than Internet firms.
13. U.S. GAO (2000), p. 17-18; From 1990 to 1996, these four states accounted for 55% of the total number and dollar amount of venture capital investments made, according to Table 1.3 in Gompers and Lerner (1999), *The Venture Capital Cycle*.



14. See Lawrence Litvak and Belden Daniels (1979), *Innovations in Development Finance*, pp. 49–50.

15. A good discussion of this issue is found in Allen E. Berger and Gregory F. Udell (1998), “The Economics of Small Business Finance: The Roles of Private Equity and Debt Markets in the Financial Growth Cycle,” *Journal of Banking and Finance*, 22, 1998.

16. From the author’s research and a survey of venture capital firms summarized in Weaver (1998), *Venture Capital Investment Patterns: Implications for Regional Economic Development*. This large minimum investment size partly reflects growth in the size of venture capital partnerships during the 1990s, which pressured managers to seek larger transactions and increase their minimum investment size.

17. *Boston Globe*, July 1, 1998, “Fed Warns Banks to Maintain Lending Discipline for Businesses.”

18. Litvak and Daniels (1979) point out that such discrimination may be a way to address high information costs (p. 22).

19. See Gregory Squires (1993), *From Redlining and Reinvestment*, pp. 12–13.

