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RURAL ECONOMIC DEVELOPMENT: NEW OPPORTUNITIES AND CHALLENGES FOR COMMERCIAL BANKERS

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Abstract

The report discusses commercial banks' role in supporting economic development in rural America. It details demographic and economic trends in rural America. It discusses a number of economic development programs available to commercial bankers and to private sector/public sector partnerships. Finally, the report proposes a set of new tools for commercial bankers to further strengthen their participation in rural community economic development.

Keywords: demographic trends, economic trends, rural America, role of commercial banks, economic development programs, new tools for bankers

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Abstract

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Highlights

* Commercial bankers have long supported national legislation that would improve their capacity to support rural economic development.

* Nonmetropolitan America has been losing population for a very long time, losing its young people after they have been educated.

* Population growth rates in rural America were lowest in counties with less than 10,000 people. Thirty-six percent of those counties had negative natural growth rates and 68 percent had declining overall population from 1983 to 1992.

* Only in counties of population 25,000 and above did average growth exceed 2 percent from 1983 to 1992.

* Nonmetropolitan counties grew by 2.5 percent from 1983 to 1992, while metropolitan counties grew nearly 11 percent.

* Nonmetropolitan employment growth for the period 1983 to 1992 was 14.7 percent, while metropolitan employment growth for the same period was 22 percent.

* Over 6,000 commercial banks are located in counties of less than 50,000 population. Smaller county populations are associated with smaller bank sizes.

* Average per capita income growth for nonmetropolitan counties slightly outpaced that of metropolitan counties for the period 1983 to 1992. However, that relationship was reversed in New England, Middle Atlantic, East North Central, and Pacific states.

* Changes in the production process, the products, and computerization of business processes in U.S. manufacturing and service industries make it more likely than in previous years that these enterprises can be successfully located in nonmetropolitan areas of the United States.

* Successful economic growth occurs in all sizes of counties, although it may be somewhat easier to achieve in counties with larger populations.

* Commercial banks are a key to small businesses acquiring the credit they need. At least 84 percent of all credit and 89 percent of short-term credit used by small businesses comes from banks.

* Research studies demonstrate a mutual dependence between commercial banks and community well-being. Healthy communities are associated with strong effective banks and vice versa.

* A broad array of federal and state programs is available to commercial banks in supporting business start-up and expansion needs of their customers. These programs provide below market interest rates, loan guarantees, grants, and mechanisms for providing limited equity positions in new businesses.

* Research results indicate that economic development efforts are most successful where private/public community partnerships are formed to support those efforts.

* Rural community commercial banks fill key roles in marshaling support and providing financial services to support rural economic development.

* Many of the most successful economic development efforts appear to be built around a service center community and its entire trade territory.

* Key issues for successful rural economic development.

* Commercial banks need additional tools if they are to be as effective as possible in supporting rural economic development. These tools include improved access to lendable funds and access to a secondary market for the sale and securitization of rural economic development loans.

* Improved access to equity and quasi equity capital in start-up and expansion businesses is also needed to support rural economic development.

* Improved access to specialized expertise in project analysis, identifying and assembling resources for a project's financing package, and ongoing management/ technology transfer support for start-up and expansion businesses are critical components of a comprehensive rural economic development initiative.

* Intergenerational transfers of community businesses and commercial farms represents an issue of growing importance to the success of rural communities. The same tools used in new business start up and expansion are also necessary to assist bankers and their communities in successful intergenerational transfers of community businesses.

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Introduction

Nearly a decade ago, Murray Lull testified before the Joint Economic Committee of the U. S. Congress on behalf of the American Bankers Association. Speaking on rural development, he identified challenges that are even greater and more immediate today (Lull 1988):

"We are concerned about the current situation (in rural America)...Policies which encourage public and private investment in rural America are a vital ingredient in rebuilding the economic base of farm communities..."

"As the basic comprehensive financial intermediaries in rural areas, banks must play a central role--by providing credit to assist new businesses, to encourage diversification in agricultural production, and to fund improvements in education and community infrastructure..."

"Local banks have a major stake in the economic health of their customers, and they are uniquely qualified to meet the credit needs of their communities."

Rural economic development represents both a challenge and an opportunity for commercial banks. With regard to the challenge, banks must seek to better understand the environment within which their communities function. For some, that is one of declining population and community business vitality. For others, it is one of population growth and business expansion. While growth is more appealing than decline, across the spectrum of community performance it is likely that banks can positively affect the long-term outcomes. But to do so will often require new initiatives by banks and a greater level of inter-community cooperation and public/private sector partnerships. Banks are uniquely positioned to be a positive force for change in this process. The opportunity is, of course, that as communities and consortia of communities experience increased economic growth, businesses and citizens within those communities--including banks--enjoy greater prosperity.

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In this paper, we:

- First, illustrate the adverse demographic and economic trends affecting rural America. It has not shared in recent national economic progress.

- Second, demonstrate commercial banking's stake in the economic health of rural America and emphasize its importance to rural economic development. That nationwide system of several thousand community-based commercial banks, close to the economic heartbeat of their communities, stands ready to shoulder a larger role in providing the financial services necessary to support economic growth.

- Third, discuss the tools and programs available to bankers and their communities to support economic development.

- Fourth, we identify new tools for commercial bankers. These will be needed if bankers are to become even more effective in supporting job formation and income generation in their communities.

This paper is intended to provide both a stimulus for renewed efforts in economic development for rural America and a foundation upon which improved private/public partnerships can be built to support such development.

Demographic and Economic Trends in Rural America

This section addresses demographic and economic trends for metropolitan and nonmetropolitan counties in the United States. The analysis is based on the U. S. Department of Commerce's Bureau of The Census data series.

Urbanization has been a long-term trend in the United States. Although rural population growth increased for a short period in the late 1960s and 1970s, more recent trends have returned to the long-term pattern of rural population loss (Brown et al. 1988). That tempo of change has increased in recent years as small towns and rural counties experienced slowing of growth and, increasingly common, natural declines in population (Johnson 1993). Though U.S. population is concentrated in county units of 50,000 population or greater, the great majority of U.S. counties have population below that level (Figure 1). All states had at least two counties of at least 50,000 population. Alaska, Wyoming, and South Dakota each had two. New Jersey had no counties of less than 50,000 population. Moreover, more populous counties were found predominantly in the areas of Wisconsin east to the Atlantic; the Washington, DC, to Boston corridor; the retirement centers of the Carolinas and Florida; and the far west and southwest. The United States is far advanced in the process of becoming a nation of cities and suburbs.

Fig. 1

The demographic characteristics of the U.S. population have been changing as well. Between 1960 and 1990, the distribution of U.S. population has shifted toward a more elderly society (Appendix A). The proportion of Americans beyond their working years also has grown substantially. Americans aged 65 and older made up 9.2 percent of the U.S. population in 1960; by 1990, that proportion had increased to 12.6 percent. Both rural and urban areas experienced those trends. The most striking change differentiating urban from rural areas is the decreased proportion of young adults in rural areas compared to urban areas. Young people, having been educated for the work force, are moving to urban areas for career opportunities. The National Governor's Association in its report *New Alliances for Rural America: Report of the Task Force on Rural Development* noted, "Between 1979 and 1986, rural areas gained new jobs at only 43 percent of the rate for metropolitan counties" (National Governor's Association 1988). Many young people would have preferred to find career opportunities closer to home and to their families (Smith 1992).

Population Growth

Population growth rates from 1983 to 1992 were lowest in counties of less than 10,000 people (Appendix B.1). Moreover, the natural growth rate (the number of births compared to deaths and excluding migration) was negative in 36 percent of those smaller counties. Sixty-eight percent of all counties with population below 10,000 had declining overall population. Among those counties with population of 10,000 to 24,999, 49.1 percent exhibited declining overall population (Appendix B.2). Only in county groupings with population above 25,000 did average growth rates exceed 2 percent (Appendix B.3). Population growth rates for counties with population of 50,000 or more people averaged 10.3 percent (Appendix B.4). Only 22 percent of those counties had declining population. Population decreases in counties with 50,000 people or more, when occurring, were associated with out migration from older U.S. cities.

Another measure commonly used to evaluate population trends is to compare growth rates in nonmetropolitan counties (in which the population is less than 50,000 and the county is not an integral part of a metropolitan center) with growth rates in metropolitan counties. By this measure of comparison, nonmetropolitan counties in the United States had lower population growth rates from 1983 to 1992 than did metropolitan counties, about 2.5 percent growth compared to nearly 11 percent (Figure 2).

When states were grouped into regions, only the New England and Middle Atlantic regions had higher average nonmetropolitan county growth than either average growth for the metropolitan counties or the states as a whole. In the West South Central and the West North Central states, nonmetropolitan population growth was negative; and in the East South Central states, it was barely positive. These three regions had the weakest average nonmetropolitan population growth in the nation.

Fig. 2

Among individual states, North Dakota, Wyoming, West Virginia, Oklahoma, and Iowa experienced the largest percentage loss in average nonmetropolitan county population from 1983 to 1992. Nevada, Hawaii, Alaska, California, and Florida registered the largest percentage gains in average nonmetropolitan county population during the same period.

Figure 3 shows those states in which nonmetropolitan growth was less than overall average growth for the nonmetropolitan United States. All Great Plains, most Midwest, and Mid-South states, plus three outlying states, had lower population growth in nonmetropolitan counties than for the U.S. nonmetropolitan counties as a whole.

Employment Growth

In the United States, nonmetropolitan counties fell behind metropolitan counties in average employment growth from 1983 to 1992. Nonmetropolitan employment growth was 14.7 percent for the period, compared to metropolitan employment growth of 22 percent (Figure 4). Average nonmetropolitan employment growth was weaker than the national average for nonmetropolitan areas across many states in the U.S. midsection (Figure 5).

Only in the New England and Middle Atlantic states was nonmetropolitan county employment growth stronger than in the metropolitan counties. Employment growth in nonmetropolitan counties was weakest in the West South Central states.

North Dakota, Louisiana, Kansas, Oklahoma, and Texas nonmetropolitan counties had the weakest average employment growth from 1983 to 1992. Hawaii, Nevada, Arizona, Florida, and Delaware nonmetropolitan counties had the strongest average employment growth during the same period. Average employment growth in North Dakota and Louisiana nonmetropolitan counties was negative for the period.

Income Growth

Average per capita income growth in nonmetropolitan counties across the United States from 1983 to 1992 slightly outpaced that of metropolitan counties (Figure 6). This apparently paradoxical relationship is likely due to five factors. First, high paying jobs have been declining or growing more slowly than lower paying jobs in metropolitan counties. Second, jobs moving into nonmetropolitan counties often pay more than those previously in the counties. Third, since average income growth in nonmetropolitan counties during the period examined starts from a low base, higher paying jobs coming into these counties have had a marked impact on their average per capita income. Fourth, low population growth in nonmetropolitan areas relative to that of metropolitan areas distorts the comparisons of average per capita income growth figures. Finally, the economic recession late in the period may have had a greater adverse impact on per capita income growth in metropolitan counties than in nonmetropolitan counties.

Fig. 3

Fig. 4

Fig. 5

Fig. 6

Despite strength in average per capita income growth at a national level, a number of regions did not share in that strength. Average per capita income growth in nonmetropolitan counties fell behind that of metropolitan counties in New England, Middle Atlantic, East North Central, and Pacific states. All other states, experienced more rapid average per capita income growth than did the metropolitan counties.

Alaska, New Mexico, California, Oklahoma, and Washington nonmetropolitan counties experienced the weakest average per capita income growth from 1983 to 1992. South Dakota, Tennessee, New Hampshire, North Carolina, and Maryland nonmetropolitan counties recorded the highest average per capita income growth.

Most East North Central, West South Central, Mountain, and Pacific States, along with two West North Central States, experienced average nonmetropolitan per capita income growth below the national average for nonmetropolitan areas (Figure 7).

Implications

A number of conclusions can be drawn from the data. First, much of nonmetropolitan America has been falling behind in population and employment growth. This continues a long term trend. Substantial variability in performance was found across individual states (see Appendix F). Especially in the nation's heartland. Both the duration of the trends and the magnitude of those changes imply the trends may not change without concerted private/public focus on rural economic development. Even then, those trends will not be reversed everywhere. Especially in those counties below 10,000 in population and with negative natural rates of population growth, reversing the trends will be extraordinarily difficult.

The nation has been building its population and economic base around larger cities and their suburbs for an extended period. Without substantial public policy support of private sector initiatives, that trend may be difficult to reverse. Broader-based economic growth is important to bring job and income growth opportunities to people residing in nonmetropolitan areas. The nation would benefit from more effective use of the human capital and fixed investment in nonmetropolitan communities.

Second, in an economy more focused on producing services and with manufacturing embodying more technology in the final products, economic growth can more easily occur in locations outside larger cities and their suburbs. While the past benefits of agglomeration in the United States appear to have been substantial, improved communications technology seems likely to reduce the advantages of urban over rural locations. Improved communication via interactive video and fax is already bridging distance and time barriers for business firms and government institutions. For example, much of the information industry has no geographically binding barriers to success.

Fig. 7

A recent study of rural counties in the Tenth Federal Reserve District concludes that nonmetropolitan counties adjacent to metropolitan counties tended to outperform those more distant from metropolitan counties. However, important examples of fast-growing rural counties were found both adjacent and nonadjacent to metropolitan counties. Fast-growing rural counties tended to rely more heavily on manufacturing, retail trade, and services than on farming and mining (Smith 1992).

Hence, no county or community should be abandoned just because it is small. Economic growth tends to occur when an entrepreneur is able to match a good idea with adequate financing and strong market demand. Though it may be more difficult to foster self-sustaining economic development in the smaller counties or communities, it can and does occur.

Third, as quality of life-style issues become more important for many Americans, locations in small cities and towns become more attractive for firms and their workers. The educational, cultural, and recreational attributes of small cities and larger towns often equal those of larger cities. Environmental problems are less pronounced and more easily managed in nonmetropolitan than in metropolitan areas. Finally, a stronger sense of place and community in these areas often means less crime and greater personal safety.

As a result, opportunities to improve job formation and income generation in rural America are available. Moreover, those opportunities may be broader than was true a generation ago. To capitalize upon those, however, will require a well-conceived private/public partnership. Commercial banks are ready with their several thousand strong community-based network to help businesses and communities build on those opportunities.

Commercial Bankings' Role in Rural America

Commercial bankers can make the difference between success and failure in their communities. Whenever successful innovation or progress occurs in a community--a new sewer, an ambulance service, or a business expansion--chances are high that the local bank had a leadership role. Leadership encompasses a range of activities, of course. Commitment of time, lending of debt capital, orchestrating development of a financial package for a business or public infrastructure project, and community cheerleader are all roles a community banker plays. Commercial banks have been the nation's primary source of credit for operating small businesses. In the most recent published survey by the National Federation of Independent Business Research and Education Foundation in 1985, commercial banks were found to provide at least 84 percent of all credit and 89 percent of short-term credit used by small businesses (Dunkelberg and Scott 1985). This section reviews linkages between community growth and banks in rural communities.

Review of Research Results

Researchers have attempted to understand the role of banks in the economic health of their rural communities. A number of conclusions can be supported. Some researchers have found evidence that changes in bank asset holdings tend to precede changes in economic activity (Lown 1990). That means bank lending activity stimulated economic activity. The same study found evidence that restrictions on bank lending adversely affected the community's economy.

Another researcher concluded that bank lending activity was a necessary condition for regional growth, but that bank lending alone was not sufficient to spur growth when other factors did not support growth (Dreese 1974). A third researcher concluded there was a mutual dependence between bank profitability and community prosperity (Gustafson and Beauclair 1990). Bank lending policies influenced economic activity, and growth in community prosperity added to the financial health of the bank. A study of bank branches confirmed that community economic activity and bank lending are related, though bank lending could not be concluded to lead to growth in retail sales in a nonmetropolitan branch bank setting (Barkley and Helander 1985).

Other researchers compared rural and urban banks. One concluded that rural independent banks and rural branch banks bring strengths to customers; but one structure was not superior to the other in serving the economic development needs of a community (Milkove 1985a).

One researcher analyzed the results of a small business survey and concluded rural borrowers pay somewhat higher interest rates than do urban customers, because of more concentrated risk in rural bank loan portfolios (McGlone 1991). Yet rural bank customers were more satisfied with their bank than were urban bank customers. The study indicated rural capital markets appeared to serve their customers as well as did urban capital markets.

Another researcher assessed bank performance across rural/urban location and bank size. He concluded bank size may be more important in determining bank response to risk than was a rural or urban location (Milkove 1985b). Small banks were more similar to each other in their response to risk than they were to large banks, irrespective of urban or rural location.

A researcher from Wisconsin concluded that state's small banks had little experience in making complex business loans (Taff et al. 1984). The key to quickly assessing a bank's preparedness to make complex business loans was its size. If it had less than about $30 million in total assets, it probably lacked the experience and perhaps the size needed to successfully evaluate and make large and complex business loans.

A survey of the academic literature indicated a strong linkage between bank lending activity and community prosperity. While researchers disagreed about whether increases in bank lending precedes increases in community prosperity or vice versa, a mutually dependent relationship was a reasonable conclusion. Without the support of a local bank, communities had difficulty exploiting economic development opportunities. With a strong and aggressive community bank, more opportunities are likely to be pursued and economic growth will be stronger, providing the broader business climate also is supportive.

Banks have a strong self-interest in assisting their communities to prosper because the banks will also prosper. Banks are unusually important to economic development, most likely more so than academic research has been able to document. One management analyst concludes banks are probably the most effective means by which small and moderate-sized businesses gain access to capital (Hagaman 1992).

The Rural Bank Delivery System

Federal Deposit Insurance Corporation (FDIC) call reports were the source of data for this section on the rural bank delivery system. Reports used in the analysis were from December 1992.

The commercial bank delivery system is a vital resource in the rural economic development challenge. Nearly every community either has a bank or is near a community with a bank. Over 6,000 commercial banks were located in counties of less than 50,000 in population (Appendix C.1). This figure only includes separately chartered banks. It does not take into account the large number of branch offices operated by these banks. Altogether, the total number of community bank facilities, fully staffed each business day, far exceeds the number of chartered banks in counties of under 50,000 population. A recent analysis prepared for the American Banker's Association using rural and urban designations, identified 6,146 rural banks at year end 1992 and 5,990 rural banks at year end 1993 (Veintemillas 1944). These data also do not include branch operations of chartered banks.

Each of these bank offices had personnel who understood the resources, strengths, and weaknesses of their community. They had developed an intimate knowledge of the technical and management capabilities of their community's businesses. They understood the leadership potential of their community's citizens. They were well-positioned to identify business opportunities and to monitor and administer economic development loans. These bankers understood their own success depended upon the success of their customers.

Yet, there are structural limitations to the role rural commercial banks can play. Many of these banks are small with inherent limitations. First, small banks cannot provide specialized project analysis and experienced loan officers that many larger rural economic development projects may require. Second, these banks may have difficulty either funding large project loans out of their own deposit base or carrying many of those inherently more risky development loans in their bank's loan portfolio. Third, many of these banks may not offer their customers the financial services larger business firms require.

Rural commercial banks maintain correspondent relationships with larger commercial banks, typically located in urban areas. The correspondent relationship provides a range of services to rural community banks. These include operational services such as check processing and wire transfer of funds, for example. Additionally, correspondent banks may participate in loans made by the community bank when those loans exceed the smaller banks' loan limits or when the smaller banks find themselves relatively illiquid because of high loan-to-deposit ratios. Loan pooling opportunities also enable a community bank to participate in loans made by the correspondent bank. Multi-bank holding companies are able to provide some of the same loan participation and loan pooling services to members of their respective holding companies.

Bank size constraints were most severe in counties with population less that 10,000 (Appendix C.2). Within these counties, fewer than 187 banks had assets of more than $50 million. Size limitations were still substantial for those banks in counties of 10,000 to 24,999 population (Appendix C.3). There, only 168 banks topped $100 million in size. Counties larger than 25,000, but less than 50,000 in population, contained a substantial number of banks above $100 million in assets (Appendix C. 4 and 5).

Diverse commercial lending experience was relatively limited at commercial banks in counties with population below 25,000 people. Agricultural and individual lending dominated these banks' loan portfolios (Appendix D). Home mortgage lending also was important in these banks.

For many small rural counties, smaller community banks very effectively serve community credit needs. This is particularly true in small communities where business activity is dominated by production agriculture. Improved profitability of farming and of businesses directly serving farmers provides the primary economic base. In that setting, meeting the credit needs of those customers may be the most important contribution a bank can make to rural economic development.

However, more rural banks are asked to provide debt capital and other financial services to larger scale and more complex economic development projects. These range from large-scale livestock production facilities, to expansion of small factories or machine shops, to commercial business expansion, to infrastructure improvements. Rural economic development projects often require lendable funds in larger amounts and with longer loan repayment terms than rural banks can comfortably provide from their local deposit base. Moreover, those loans also entail risk concentrations that cause concern for both bankers and their regulators.

Economic Development Programs Available to Bankers

Many programs to support economic development have been created over the past two decades. These include federal, state, and local government and private/public partnership programs. This section is intended to identify and briefly discuss a range of programs that are available to bankers to improve their capacity to support rural economic development. The programs are discussed under three sections: regulatory programs that are required by federal or state law, a group of programs that are permissive in nature and have the capacity to strengthen the performance of banks in their support of rural economic development lending, and public policy initiatives available to banks that enable them to create special purpose development entities and state assistance programs. This section identifies and discusses the more important of these. The discussion draws, among other sources, upon a National Center for Policy Alternatives publication, *Financial Deregulation: New Opportunities For Rural Economic Development* (Siegel et al. 1986).

Regulatory Programs

The following regulatory tools imposed by federal or state governments require banks to achieve a range of public purpose responsibilities. They do not, however, require banks to engage in unsound lending when sound loan proposals, from a regulatory perspective, are not available. They do, however, create a process that banks must follow to assure all members of their trade areas have access to banking services.

- The *Community Reinvestment Act* (CRA) enacted at the federal level in 1977 requires all federally chartered and/or insured financial institutions to meet certain regulatory standards for providing lending and other banking services to low and moderate income customers of a bank's trade area and to meet its legitimate service needs. The intent of the legislation and implementing regulations is to assure full access to banking services by all income and racial segments of a banking trade area. Many states have enacted similar legislation for state-chartered financial institutions, often using language similar to the federal law. Compliance with these requirements is through the regulatory process in which financial institutions are graded on their CRA performance.

- Some states have enacted and others have considered *net new funds requirements* for nonstate banking institutions wishing to acquire an instate bank. These requirements are enforced through state bank regulatory agencies. The intent of such legislation is to assure states and communities the same access to lendable funds after bank consolidation as before. Other states may choose to consider such legislation if federal branch banking legislation, now under consideration, triggers a new wave of bank consolidation.

- *Lending disclosure laws* at the federal and state levels are intended to bring lending activities of a bank to public attention in the local community. These laws cover one or more of the following lending activities of a bank: home lending, small business lending, and commercial and consumer lending. They require at least an annual disclosure of a bank's activity in the specified lending categories.

Initiatives To Strengthen Bank Performance

A number of initiatives have been developed to strengthen bank performance. These include efforts by bankers, by local and state government, by the federal government, and by public/private partnership.

- *Bankers' Banks* may be developed and owned by a consortia of independent banks to provide specialized banking services for their owners. These banks may be chartered under either federal or state authority and are regulated by the chartering authority.

As the customer demand for sophisticated banking services has grown, and as correspondent banking relationships have become less advantageous to many smaller banks, a bank owned by and dedicated to serving the needs of its smaller bank owners has become more appealing. Bankers' banks provide a span of services to their owners, including check processing, investment services, loan participation, secondary market services, data processing, pooled access to national capital markets, and education/training for employees of the owner banks.

- *Pension Fund Targeted Certificates of Deposit* have become a means of providing commercial banks with deposits, the maturities of which are compatible with financing the longer-term debt capital needs of start-up and growth businesses. State and local government pension funds are a typical source of targeted certificate of deposit funding. The funds, usually in $100,000 amounts, are fully insured by the Federal Deposit Insurance Corporation, placed at competitive rates of return, and are directed toward banks that demonstrate the willingness and ability to make net new debt capital available to businesses in their trade areas.

- *Linked Deposits* are used by governmental units of a number of states and cities to direct debt capital toward enterprises deemed to be in the public interest, often small businesses and start-up firms.

These deposits may enable a bank to lend at lower interest rates or for longer terms. Deposits are made available with the understanding that the bank will increase net new lending and, perhaps, provide below-market interest rates to start up businesses and other firms targeted by the linked deposit programs. Banks are required to pledge securities to back these public sector deposits.

- *Loan Guarantee* programs are widely used by both the federal and state governments. The programs enable banks to lend to firms and individuals not credit worthy by usual bank underwriting standards. Both the USDA's Rural Development Administration (RDA) and the Farmers Home Administration (FmHA) make available guarantees for business and industrial lending in rural communities. The FmHA also makes guarantees available on farm loans for low resource farmers. The Small Business Administration (SBA) provides guaranteed and insured loans under its "504" Certified Development Company program and guaranteed/direct loans under its Small Business Loans program. The Department of the Interior's Bureau of Indian Affairs (BIA) provides guaranteed/direct loans to Native Americans for economic development.

Many states operate programs providing loan guarantees/direct loans to start-up and growth businesses. In North Dakota, for example, the state-owned Bank of North Dakota provides a broad program of loan guarantees/direct loans and loan participation with other lenders to support economic development lending by the state's financial institutions. Most states with these loan programs include agricultural producers among the firms eligible for such assistance.

Public Policy Initiatives

The following programs represent public policy initiatives, at federal, state, and community levels, focused on enabling banks to create and/or work with special purpose entities that provide financing and technical support to economic development efforts.

1. Initiatives for Lending Institutions

- A *Bank Development Corporation* is formed as a wholly owned entity of a commercial bank. Capitalized by the bank, the corporation may provide debt and equity capital, specialized training, and residential/commercial project development. Approval for these corporations is granted by the Comptroller of the Currency for national banks, by the Federal Reserve Board for bank holding companies, and the Comptroller of the Currency and state bank regulators for multibank corporations. These entities are used to support development of property and job formation in low income areas of a bank's trade area.

- *Capital Resource Corporations* are privately managed and capitalized corporations formed by a consortium of banks or other institutional lenders. They are chartered under state legislative authority and provide long-term debt and equity capital for higher risk rural firms. In creating these corporations, states specify target objectives the corporation is to pursue, such as lending or investing in agricultural processing facilities. Penalties are levied against corporations failing to meet prescribed target objectives. For example, penalties could remove certain tax preferences granted to firms that capitalize such a corporation.

- *Business Development Corporations* are privately capitalized and managed lending institutions created to provide intermediate-term and subordinated lending for small- and medium-sized businesses. These firms are state chartered, regulated as nondepository lending institutions, and owned by financial institutions. Their lending authority is statewide to financially sound firms unable to obtain financing from regular market sources. The success of loans extended by these entities has been mixed. Moreover, many have remained relatively inactive after formation.

- *Business and Industrial Development Corporations*, similar in concept to business development corporations, are more specialized financial institutions chartered by a state to serve defined small business financing needs. They can be owned by individuals and financial institutions or by a government entity. They operate on <u>less than a statewide basis and usually specialize in making federally guaranteed loans</u>.

2. Initiatives for a State

● *State Rural Development Finance Corporations* work closely with community development corporations to support housing and economic development efforts in local communities. With federal funding no longer readily available, state or local finance corporations have become critically important as capital sources for community development corporations. The <u>finance corporations provide community development corporations with high risk equity capital</u>. Alternatively, the finance corporations may provide debt and equity capital to ventures initiated by the community development corporations.

3. Initiatives for Communities and Public/Private Partnerships

● *Rural Venture Capital Corporations* usually are privately capitalized, but often enjoy some government support such as tax relief. They <u>focus on purchase of equity or quasi equity in small rural businesses</u>. Where successful they have been focused in their mission, professionally managed, and have followed a practice of strict accountability to the public. These firms can fill important risk capital gaps in financing start-up and growth businesses.

● *Rural Community Development Corporations* are community-based organizations focused on spurring housing development and other economic development within a specified geographic area (Nickel 1992). Most were initially capitalized with federal funds. State governments, private firms, and foundations now are more common sources of capitalization and operating funds. They <u>provide development assistance, including equity investment, low-cost loans from revolving funds, technical assistance, and loan guarantees</u>. Tax incentives are sometimes provided to private firms as an inducement to invest in these corporations. A large number have been formed across the United States.

● *Rural Financial Technical Assistance Organizations* are organized as community assistance groups. These organizations may <u>operate technical support and education programs assisting banks in using various public sector financing tools</u>, such as guaranteed loan programs and secondary market opportunities. Many have negotiated with banks to create agreements on certain specified focused lending activity. Those agreements involve special efforts to make credit available to low income or other disadvantaged areas within a bank's trade area.

● *Revolving Loan Funds* are <u>locally administered funds often used by nonmetropolitan communities to support rural economic development</u>. Many such funds received their initial capital as pass throughs of state or federal economic development loans directed toward local firms. As those loans were repaid, the funds became available for relending by the loan fund. The success of these funds has varied. A Minnesota-based study reported in that state few new loans had been made from the repayment proceeds of the initial loans that capitalized the funds (Stinson and Lubov 1986).

Federal and state governments have been creative over the past three decades in developing targeted programs to help private firms fill gaps in their access to start-up and expansion financing. Federal programs provide grant, direct loan, and loan guarantee assistance.

Most federal programs are designed to partner with state/community entities and financial institutions to deliver assistance to private firms. Federal programs are national in scope or are targeted toward assisting firms or individuals meeting specified selection criteria. State programs also tend to be sharply focused.

These initiatives require special efforts by, and a high level of cooperation among, lenders, local businesses, and community organizations. To be successful, the initiatives also require specialized expertise that may not be readily available in a rural community. Finally, these organizations require capitalization by community lenders, businesses, and organizations. For all of these reasons, these initiatives have enjoyed only limited use. Yet, initiatives offer substantial promise to spur increased economic development for those communities in which public and private sector partnerships are created.

State Assistance Programs

In addition to financial assistance, states provide a varied menu of support programs for economic development. These reflect a recognition that financial assistance is seldom sufficient to assure successful economic development projects.

Most start-up ventures require feasibility studies. Many require special tax relief. In the case of large projects, special legislative initiatives often are used. Large complex projects may require legislative incentives tailored to a specific project.

Once in operation, start-up and expansion businesses often require specialized training and technical support along with business management assistance to assure their success. Appendix E identifies the more commonly available support programs in each of the 50 states.

A Comprehensive Approach to Economic Development

Rural community banks and their communities are joining together to make rural economic development happen. As a result, the emerging approach to this effort is more comprehensive and more strategic than in the past.

Despite the government and private sector programs to aid rural economic development, success has been more difficult to achieve and less predictable than policymakers and business leaders had envisioned. Federal government funding of programs has become more difficult to obtain and available only in smaller amounts. Identifying and obtaining assistance from the right combination mix of public programs and private sector initiatives has become increasingly challenging as the array of programs has grown. Few new projects can be put together using the resources from only a single program. Communities working in isolation face increasingly daunting challenges in obtaining a critical mass of resources and development momentum to achieve sustainable rural economic development (Barbash 1992).

Consequently, communities across the nonmetropolitan United States are rethinking how they can accomplish rural economic development. Successful communities increasingly think in terms of rural economic development strategies, rather than simply of isolated projects (Leaman et al. 1992) (Appendix E).

Defining a community's goals is important. Community leaders must understand the economic base upon which they will build. Experience indicates a community's private sector is the primary economic motivator and an integral component of successful development. Hence, the business leadership must be involved in economic development planning and execution. Community leaders must be honest with themselves and their community in charting a strategy for development and a plan to implement that strategy. In all of this process, the community bank has a fundamental role as visionary, energizer, facilitator, enabler, and pragmatic doer.

The strategic role of entrepreneurship in spurring economic development is becoming better understood and more highly valued in rural areas (Scharre 1992, MacKenzie 1992, Flora and Flora 1990). This has resulted in new partnerships among the private sector and state/local governments. These partnerships are catalysts for progress. They provide technical and educational assistance to build a community's human resource base. They also provide technology transfer and management support. Financing alternatives are created. Disincentives to risk taking are reduced, and greater recognition for achievement is encouraged. Basic infrastructure needs are identified, and investments are undertaken.

A cooperative model of economic development recognizes that communities within a broader trade area are bound together in many ways by shared opportunity that can better be realized through cooperation than through competition (Zoellner 1992, Daniels 1986). Cooperation makes the area more attractive to more firms. Larger development projects can be undertaken. Cooperating communities have learned that new jobs and a higher quality of life anywhere within the trade area benefit everyone. Some communities become bedroom communities; others develop specialized services or manufacturing. Economic development becomes a win-win game in which all participants can benefit.

Minot, North Dakota, and its trade area provide an example of such cooperation. Minot has a population of 34,544 and its trade area of 5,040 square miles has a total population of

65,728. The Minot Chamber of Commerce, Minot Area Development Corporation, Souris Basin Planning Council, the local Small Business Development Center, and Minot State University's Business and Community Assistance Center all work together with the Minot Magic Fund to retain, expand, and attract business activity to the Minot trade area (Lucy and Des Laurirs 1994). The Minot Magic Fund is built around a 1 percent sales tax in the city of which 40 percent of the proceeds are ear-marked for economic development. The Magic Fund assists in financing development projects and is administered by the city council.

The service area for economic development entities in Minot stretches well beyond the city limits. The Magic Fund has supported projects in outlying communities near the Montana border; north to the Canadian border; in north central North Dakota; and in the southwest quadrant of the state. Initiatives outside the city are a part of an economic development approach that holds, "what is good for the trade area is good for Minot." This spirit of cooperation is further manifested in the local policy toward new business recruitment. Marketing of the city and trade area to businesses interested in relocation only occurs outside North Dakota. Minot economic developers do not perceive benefit in relocating businesses from within their trade area to the city.

A broad view of community and a spirit of service for the good of the whole has worked well for Minot. The city and trade area with its 10.27 percent increase in population from 1980 to 1990 remained among only 10 trade areas in North Dakota to experience growth (Leistritz and Wanzek 1993). Real per capita income in the area increased by 4.25 percent from 1979 to 1989, and real taxable sales and purchases increased by 2.23 percent from 1980 to 1992. Finally, employment in Ward County, where Minot is located, increased 7.23 percent from 1980 to 1992. In some parts of the country this performance may seem modest, but in North Dakota where many of these measures have declined over the last decade, it is indicative of strong leadership in pursuit of economic growth.

Experience suggests that successful rural economic development results from successful process and teamwork. All the essential components must be available. Three predictors of success stand out. These are **leadership**, **cooperation**, and **commitment** of key people (Leaman et al. 1990).

Whether development is pursued on an individual community basis or on a more regional basis, rural community banks are essential to the process and to its success (Markley and Shaffer 1993, Prestwich 1988). They are catalysts within their communities in stimulating economic development planning. Their participation in providing financing to public and private projects is becoming more important as public sector funding, especially federal government assistance, becomes less available. However, banks find they are not yet fully equipped to deliver on the increased expectations of their communities. They need additional tools to successfully meet the growing challenges.

New Tools for Commercial Banks

Many programs are available to support rural economic development. Most are quite specialized and require community action to implement. Rural community banks have pivotal roles to make these programs work. Rural economic development success often hinges on a balanced package of tools used by rural community banks. However, as a more comprehensive view of rural economic development emerges, bankers need additional tools. This section identifies those tools. The tools would support the bankers in their access of lendable funds, in risk management, in helping to secure equity capital for new businesses, in providing specialized project analysis and business management expertise, and in supporting the intergenerational transfer of existing community businesses.

A New Source of Lendable Funds

In a number of nonmetropolitan credit markets, rural community banks are experiencing shortages of lendable funds as their loan-to-deposit ratios have climbed past 70 percent. In those markets, access to U.S. capital markets could augment their lendable funds, supporting more aggressive lending for all purposes--including rural economic development loans.

Banks also need the capacity to acquire lendable funds in packages sized to meet the debt capital requirements of economic development project proposals. Rural community banks are often asked to provide larger debt capital financing than can readily and prudently be assembled from the banks' own deposit base. Acquiring lendable funds from other sources to meet these requests must be cost effective for the commercial bank. A new supplementary source of lendable funds could assure that banks are able to meet the ongoing growth in loan demand by current customers and the growing number of economic development loan requests.

Banks must be able to match the maturities of lendable fund sources with the maturities required for economic development loans. Maturities on most commercial bank deposits are relatively short, primarily under three years. However, economic development loans frequently require maturities of several years or more. Projects in which the payback capacity is measured in terms of a decade or more are not uncommon, as is true with many public sector infrastructure loans.

A Secondary Market for Economic Development Loans

Banks need a secondary market into which they can sell economic development loans. If banks are to remain active in economic development lending, they must have the capacity to replenish their lendable funds through the sale of loans from their loan portfolios to reliquify those portfolios. Many economic development projects require large amounts of debt capital. Rural community banks, most of which are relatively small, will find it too risky to carry large volumes of such loans in their own portfolios. Their regulators will not permit them to do so. Finally, rural community banks can no longer always rely on being able to participate in these loans with a correspondent bank, when needed and in the amount required.

Equity Capital

Economic development practitioners and businessmen emphasize the importance of a balanced package of capitalization for start-up and growth businesses (Duncan 1994). Access to adequate debt capital cannot replace access to equity investment in assuring financial success for private sector economic development projects. Most businesses require more than 40 percent equity to build financial success. Many successful businesses target 60 to 70 percent equity as a prudent business practice.

Equity investments can be stock purchases or other equity ownership. Quasi equity investments, such as preferred stock and convertible debentures, can serve the role of equity in the early years of a firm and later be redeemed by the firm or converted into common stock in the firm. Increased attention to rural economic development means rural community banks are likely to seek out equity and quasi equity investment mechanisms, to support firm start up and expansion, in addition to providing debt capital products.

Specialized Expertise

Rural economic development practitioners increasingly recognize the importance of specialized expertise to assist lenders and their customers in creating successful business ventures. Three types of specialized assistance are needed by rural community banks to support their rural economic development lending. First, rural banks need access to specialized project analysis to evaluate the feasibility of economic development projects and to support development of appropriate debt or equity products for the proposed project. Second, banks need access to a team of specialists to identify and put together the various grant, loan, and loan guarantee programs offered by federal, state, and local governments (U.S. General Accounting Office 1994). Third, banks lending to start-up and growth businesses may require the loan customer to obtain specified technical and management support services.

Intergenerational Transfers

Successful intergenerational transfer of existing community businesses has posed a growing challenge to rural community banks and to businesses in their communities. These banks must acquire tools to become more effective in providing or participating in financing intergenerational transfer of existing community businesses.

Transferring ownership of existing businesses from one generation of ownership to the next has become increasingly important to the survival and growth of existing businesses in nonmetropolitan America. Too often thriving businesses leave rural communities or become financially crippled because adequate financing packages are not available to support their intergenerational transfer.

Ironically, although heretofore largely a problem for nonfarm businesses, commercial farms have now grown in size beyond the practical capacity to be recapitalized each generation. Hence, farm businesses now face the same intergenerational transfer problems experienced by nonfarm businesses.

Conclusion

Rural America has fallen behind urban America in building economic prosperity. Population trends that briefly turned positive in the 1970s have again turned negative. Employment growth and, in some regions, income growth continue to lag behind urban America.

Manufacturing and service firms in rural America have become more important as sources of employment; on-farm agriculture employment has declined substantially. Though agriculture remains important in many rural areas, the role of other economic activities has grown. Technological change, improved communication, and the growth of a services industry have diminished the geographic disadvantage of many rural areas as business locations. Stronger rural economic development efforts may produce increased job and income growth for many rural communities.

Rural community banks are well-positioned to support rural economic development. Each of several thousand commercial banks across rural America is deeply committed to its community. The bank's economic welfare depends upon that of its community or trade area.

Government bodies have created specialized programs and institutions to support economic development efforts. However, some additional tools are needed if banks are to become as effective as possible in this process.

Banks need efficient access to national capital markets to secure cost-effective, lendable funds for economic development projects and to match the maturities of rural economic development loans to the repayment capacity of those projects. Banks also need access to a secondary market in rural economic development loans. That would permit them to reliquify their loan portfolio, better manage the risk associated the these loans, and become more active in rural economic development lending.

Improved access by rural banks to specialized expertise for rural economic project development and ongoing technology and business management support would further improve the climate for successful rural economic development.

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APPENDIX

Table E1. Economic Development Assistance Programs by State

State	Training	Feasibility	State Pur	Tech Net	Loan Assist	SB Con
Alabama	✓	✓	✓		✓	✓
Alaska	✓				✓	✓
Arizona					✓	✓
Arkansas			✓	✓	✓	
California	✓				✓	✓
Colorado	✓			✓	✓	✓
Connecticut			✓		✓	
Delaware	✓				✓	
Dist of Columbia					✓	✓
Florida	✓		✓		✓	✓
Georgia	✓		✓		✓	✓
Hawaii	✓		✓	✓	✓	
Idaho		✓			✓	✓
Illinois			✓			✓
Indiana			✓	✓	✓	
Iowa	✓				✓	
Kansas	✓			✓		
Kentucky	✓	✓			✓	✓
Louisiana						
Maine						✓
Maryland			✓			✓
Massachusetts					✓	
Michigan				✓	✓	✓
Minnesota			✓		✓	
Mississippi			✓			✓
Missouri	✓		✓	✓		
Montana			✓		✓	✓
Nebraska	✓	✓			✓	✓
Nevada						
New Hampshire	✓					
New Jersey			✓		✓	
New Mexico			✓			
New York	✓		✓	✓	✓	✓
North Carolina			✓	✓	✓	
North Dakota	✓				✓	✓
Ohio						✓
Oklahoma	✓		✓	✓	✓	✓
Oregon	✓				✓	✓
Pennsylvania				✓	✓	
Rhode Island					✓	✓
South Carolina			✓		✓	✓
South Dakota	✓					✓
Tennessee			✓		✓	✓
Texas	✓				✓	✓
Utah					✓	✓
Vermont	✓					✓
Virginia			✓	✓	✓	
Washington					✓	
West Virginia					✓	✓
Wisconsin			✓			✓
Wyoming	✓				✓	✓
Total	22	4	23	12	37	32

Source: Small Business Administration, Washington, DC.

Table E1. (Continued)

State	Minority	Marketing	Tax Benefit	Legislation	Enterprise	Total
Alabama						5
Alaska	✓	✓		✓		6
Arizona		✓		✓		4
Arkansas	✓	✓		✓		6
California	✓	✓		✓		6
Colorado	✓	✓		✓	✓	8
Connecticut				✓		3
Delaware						2
Dist of Columbia	✓	✓		✓		5
Florida	✓	✓		✓		7
Georgia	✓	✓		✓		7
Hawaii		✓		✓	✓	7
Idaho	✓	✓		✓		6
Illinois	✓	✓		✓		5
Indiana	✓			✓		5
Iowa	✓	✓		✓		5
Kansas	✓	✓		✓	✓	6
Kentucky	✓	✓		✓		7
Louisiana		✓	✓	✓	✓	4
Maine		✓		✓		3
Maryland	✓			✓		4
Massachusetts	✓	✓	✓	✓		5
Michigan	✓	✓		✓		6
Minnesota	✓	✓		✓	✓	6
Mississippi	✓		✓	✓		5
Missouri	✓	✓	✓	✓	✓	8
Montana		✓	✓	✓		6
Nebraska		✓		✓		6
Nevada		✓				1
New Hampshire		✓				2
New Jersey	✓	✓		✓	✓	6
New Mexico		✓				2
New York	✓	✓		✓		8
North Carolina						3
North Dakota		✓	✓	✓		6
Ohio	✓			✓		3
Oklahoma		✓		✓		7
Oregon	✓	✓		✓		6
Pennsylvania	✓	✓	✓	✓	✓	7
Rhode Island	✓	✓		✓	✓	6
South Carolina	✓			✓		5
South Dakota		✓		✓		4
Tennessee	✓	✓		✓		6
Texas		✓		✓	✓	6
Utah	✓	✓		✓		5
Vermont		✓		✓		4
Virginia	✓	✓		✓		6
Washington	✓	✓		✓		4
West Virginia	✓					3
Wisconsin	✓	✓	✓	✓	✓	7
Wyoming		✓		✓		5
Total	32	41	8	44	11	

Source: Small Business Administration, Washington, DC.