DEVELOPMENT FINANCE AND REGIONAL ECONOMIC DEVELOPMENT

Andrea Levere
Bill Schweke
Beadsie Woo

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expanding economic opportunity

777 N Capitol St NE
Suite 800
Washington DC 20002
Ph: 202.408.9788
www.cfed.org

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INTRODUCTION

Increasingly, regions are emerging as the principal unit of economic competition and strategy in America. The real economy is not bounded by conventional government jurisdictions; production, consumption, communication and commerce flow across city, county and state lines. Healthy sub-state regional economies trade with other economies beyond their boundaries, and city and county governance structures do not line up easily with regional concerns or the geography of sub-state economies. State policymakers have the fiscal resources and often the right perspective on what's needed to make a difference, but state capitols are often too far from the action at the grassroots level to have the local economic intelligence needed to craft the best policy solutions. Regional and local development practitioners and institutions have an important role to play in framing the economic futures of their regions and ensuring that economic benefits are truly inclusive.

This paper shares current and promising practices that link innovation in development finance to the promotion of regional economic development that aims to raise incomes and wealth for low-income people. It includes promising strategies underway to promote regional economic development through development financial institutions, as well as leading innovations in workforce development. While this paper describes a strong role for development finance institutions in regional development efforts, it presumes that development finance is just one component of a complex nexus of services and resources that lead to economic growth. Capital is rarely the first need of a region, and the effectiveness of any one development financial institution, program or initiative depends on complementary investments in workforce and entrepreneurship skills, infrastructure, education and other social services.[1]

The paper is organized into three sections. It begins by framing the connection between development finance and financial innovation that expands access to economic opportunity for low-income individuals and communities. Second, it describes the current state of regional economic development practice, the challenges to successful initiatives, and current efforts that involve development finance. Finally, it examines a number of options for the development finance field to facilitate and lead regional economic development strategies.[2]

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[1] For more on this issue, see: Julie Ann Parzen and Michael Hall Kieschnick. (1984). *Credit Where It's Due: Development Banking for Communities.* (Philadelphia, PA: Temple University Press); Lawrence Litvak and Belden Daniels. (1979). *Innovations in Development Finance.* (Washington, DC: Council of State Planning Agencies); and Karl Seidman. (2005). *Introduction to Development Finance.* (Thousand Oaks, CA: Sage Publications).
[2] This paper draws on discussion by development finance experts at a meeting held in Washington, DC on October 27-28, 2005. Appendix A contains a summary of the recommendations made by the group.

DEVELOPMENT FINANCE AND FINANCIAL INNOVATION

The size and nature of the flow of capital to businesses and projects is affected by the economy, interest rates and the quality of the demand. It is almost impossible to overstress the importance of the demand side. Poor propositions, planning and management can shrink the pool of potentially viable deals. It is also true that those with less wealth and fewer connections fare badly in securing a good spot in the capital queue. Despite the strength of the firm or the project, a company or development project cannot always get the right amount of capital at the right time on the right terms. Discrimination on the basis of race, gender, location and/or firm characteristics also inhibits investment and lending.[3]

Development finance addresses imperfections in the private markets for capital. The absence of such finance can impede the economic development process. Typically, these barriers are grouped into two categories:

- **Misallocation**: Despite competitive expected rates of return, capital is not flowing to ventures.
- **Social/public benefits**: The capital market is operating efficiently (i.e.—capital is moving to projects of highest yield), but the private yield is not high enough to justify the risk because non-pecuniary, social benefits are not being incorporated. Minorities, women, immigrants, and/or low-wealth business owners that serve the community need new private investments as do cooperatives, community development corporations (CDCs) and employee buyouts.[4]

Over the past thirty years, there have been measurable improvements in increasing access to capital for those who are not served by formal financial institutions and markets. In fact, with the exponential growth of the "fringe banking industry," poor communities have often been plagued with too much capital—usually priced on predatory terms. Simultaneously, the development finance field has challenged conventional wisdom about the capacity of poor people to make productive and responsible use of financial services. Today, we know poor people can save given the appropriate incentive structure, and low-income entrepreneurs can succeed at their businesses and repay their loans.

The work of development finance institutions (DFIs)[5] has influenced the terms of the policy debate by demonstrating how financial services and institutions should serve the poor—

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[3] Daniels, Belden Hull and Michael Kieschnick. (1979). *Development Finance: A primer for policy makers*: *Part one* (Washington, DC: The National Rural Center), p.18. This development finance framework is based on the foundational work in the 1970s by Belden Daniels, Michael Kieschnick, Larry Litvak, Stephen Michelson, and David Smith. Also see publications cited in footnote 1.

[4] Daniels and Kieschnick.

[5] "Development finance institution" is used as a generic term to refer to a range of alternative financial institutions including microfinance institutions, community development finance institutions and revolving loan funds.

responsively, professionally and efficiently. DFIs are the brokers who exchange capital and information, speaking the language of financial markets to capitalists and the language of community and business development to low-income savers and entrepreneurs. They have demonstrated the merits of investing capital to earn social as well as economic returns and of crafting public policy to provide the financial incentives necessary to underwrite social returns on a sustainable basis.

DFIs have steadily built credibility as permanent players in financial markets. They perform two primary functions: 1) They work with private sector financial institutions to provide catalytic capital resources, means of risk reduction or other financial incentives to secure and/or leverage the involvement of mainstream finance; and 2) They deliver products and/or services to widen ownership and economic opportunities for marginalized individuals, firms and communities. This second function often engages DFIs in the role of market "maker" as they demonstrate the capacity and credit worthiness of individuals, enterprises or communities disconnected from the mainstream economy. Each of these requires closer examination.

The Mission and Scale of DFIs

Over the past three decades, the success of the development finance industry in bringing mainstream financial institutions into communities and markets that were previously underserved has raised new questions about the appropriate mission and scale of DFIs in today's market. Among DFIs, the concept of "scale" evokes different ideas, among them scale in product, organization and industry, taking an organization to scale within a region, and achieving scale in a region.[6] One of the most promising trends within the development finance industry is the evolution of DFIs into significant institutional forces in regional economic development, whereby the DFI leverages its financing role with complementary products and services that address workforce development needs, community facilities and education, while also taking on civic intermediary roles.

DFIs have demonstrated that nonprofit organizations can lend money effectively and securely, while designing and testing products later adopted in whole or part by private financial institutions. Statistics on development finance give a clear picture of these accomplishments. The CDFI Data Project (CDP) surveys community development financial institutions (CDFIs)[7] to collect information on performance and outcome. The CDP estimates that there are between 800-1000 CDFIs currently operating in the United States, including:

- More than 500 community development loan funds;

[6] Gregory Ratliff and Kirsten S. Moy, *New Pathways for Scale for Community Development Finance,* Profitwise News and Views. Federal Reserve Bank of Chicago. December 2004.

[7] The CDP is the most comprehensive source of information on CDFIs, and there are no comparable sources for information on other DFIs. The statistics reported here are indicative of the widespread and growing development finance industry.

- More than 80 venture capital funds;
- More than 275 community development credit unions; and
- More than 50 community development banks.

The most recent data collected from the CDP (FY2004) were collected from 517 CDFIs. Collectively, these institutions held $18.3 billion in assets and underwrote $12.2 billion in loans and investments in Fiscal Year 2004 with a net charge-off ratio of just 0.55%. This included 6,887 businesses that created or maintained 28,330 jobs, the construction or renovation of 43,160 units of affordable housing, and 470 community facilities in economically disadvantaged areas.[8]

Development finance institutions are more than the alternative to mainstream banks and conventional venture capitalists. However, further legitimizing their place in the U.S. capital market and gaining widespread acceptance will move the industry toward resolving the question of scale. These will require that:

- The public understands what a DFI is and how it differs from a mainstream bank;
- Every region has at least one sustainable DFI (that is, its revenues exceed its costs) and that those that require permanent subsidy identify which operations drive those costs;
- DFI staff meet professional standards and have the credentials required for the job;
- The development finance market operates smoothly, eliminating areas of over- and under- capitalization; and
- There is a strong secondary market operation for selling a significant percentage of DFI loans and investments.

Product Innovations

The second, equally important function that DFIs perform is as product developer. In this role, DFIs share and/or sell off their innovations to larger (often private) financial intermediaries that are better able to commercialize fully the new and proven product or service. DFIs serve as pathfinders, creating new mechanisms or catalytic capital resources that encourage substantial mainstream private sector involvement. For any given DFI, there may exist a tension between giving a winning strategy to others and becoming sustainable. To what extent is a development financial institution like a good community organizer in that doing a good job of building capacity puts it out of business? For DFIs, this may mean leading the way for private intermediaries to commercialize a product.

There are several promising areas of product and process innovation currently underway in the industry that aim to address key market gaps in capital access for low-income communities:

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[8] Opportunity Finance Network. (2005). *CDFIs: Providing Capital, Building Communities, Creating Impact*, *FY2004*. Retrieved on 5/19/06 from http://www.opportunityfinance.net/customer/home.php?cat=261&XCARTSESSID=85cdad5a2095ae683ccf0b0e5b9bd8e6.

- **Risk debt capital for growing business**: This provides medium-term, permanent working capital finance for growing companies that have the promise of job creation.
- **Royalty financing**: This form of risk capital blends equity and debt. Royalty agreements provide businesses with risk capital without having to give up shares in the company or having to service debt before sales can support it. These agreements often allow the firm to pay the investor *after* the customer has paid the firm, conserving valuable cash flow for the company while preserving local ownership.
- **Community development venture capital**. The economically disadvantaged rarely have the access to the major source of capitalization for business in this country: private loans from friends, family or associates. Their projects are less likely to meet the return on investment expectations of small business financing "angels" or traditional venture capitalists. Over the past decade, a cluster of community development venture capital funds have been created that blend both financial and social returns while providing equity capital to new and expanding companies.
- **Securitization and secondary market strategies**. DFIs are becoming increasingly sophisticated at leveraging the capital markets to increase their sources of funds. Organizations such as the Community Reinvestment Fund have achieved both financial success and scale by underwriting and packaging economic development, housing and other loans and selling them to private investors or directly to the capital markets.
- **Planning and financing business succession**. A very common and preventable cause of business closings is the failure to plan for succession. Too few firm owners make comprehensive plans for their businesses when they themselves are no longer willing or able to run operations. Barring qualified and interested heirs to take over, small business owners must find a buyer, which can be difficult even when the business is self-sustaining. Education and technical assistance can teach owners about the array of options available to them. DFIs assist in this process by financing employee ownership strategies, acquisitions by a minority entrepreneur or internal management takeovers.

Development finance innovation can also come in less traditional forms. In addition to those new products and services that DFIs generate themselves, innovation can emerge through changes in the tax code. For example, tax reform that curbs unintended tax-induced risk aversion; tax incentives that promote seed funding for startups, inner-city investments or other development priorities; market-based or shared-appreciation investment strategies; and the creation and capitalization of new public, nonprofit or private financial intermediaries are powerful strategies for enhancing economic growth and equity. In this paper, we will focus on this last innovation as the primary delivery vehicle for financial innovations that promote equitable approaches to regional economic development.

Regional Economic Development Strategies

Regional efforts have the potential to reach scale when moving in concert with larger economic and policy trends, such as interest in economic development strategies that yield high-quality jobs, environmental stewardship, increased global integration (instead of fragmentation from outsourcing and offshoring), and the importance of human and social capital in economic development and community building. "Regional economic development for all" is what's required to address the evidence that regional economic disparities are growing. Thus, it is important to think and act as a *region*, and not always as a state, urban, rural, city or town.

It is robust regions that will spur economic development that benefits all residents. There is growing interest in building dynamic industry clusters and in tackling a host of other problems including transportation, open space preservation and tax base sharing. Serious region-wide planning and action efforts have yielded real and continuing results in locations ranging from south Florida to greater Seattle. Portland, OR and surrounding communities have implemented the nation's most far-reaching regional growth limits and management strategy. The Kansas City region has tackled educational inequities in a serious and successful fashion. Regional tax-base sharing is happening in the Akron area.[9]

Development professionals in Michigan are supporting regional clusters in a variety of sectors. For example, The Right Place, Inc. is a nonprofit that works to disseminate best practices in integrated supply chain management in Western Michigan to keep supply chains from moving abroad.[10] Elsewhere, policymakers are working to ensure that central cities play key roles in the wider economy that link their residents to jobs. Where inner cities face declining populations, work is underway to revitalize them by improving amenities, promoting job creation and attracting middle-income residents.

One organization that specializes in inclusive regional development is PolicyLink. It has been researching the interplay between sprawl and regional inequities and the resulting isolation of low-income communities and communities of people of color from jobs and housing. At its core, PolicyLink seeks to "ensure that individuals and families in all communities can participate and benefit from economic growth and activity throughout the metropolitan region—including access to high-performing schools, decent affordable housing located in attractive neighborhoods, living wage jobs, and proximity to public transit and important amenities, such as supermarkets and parks."[11] The organization has aligned itself with the Smart Growth movement in order to create a broader and more financially diverse coalition of activists and organizations to pursue a new vision of regional equity.

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[9] Personal communication with Farley Peters of CitiStates on May 3, 2006.

[10] For more information, go to http://rightplace.org/supplychain/council.php.

[11] Angela Glover Blackwell and Radhika K. Fox, *Regional Equity and Smart Growth: Opportunities for Advancing Social and Economic Justice in America.* Funders Network for Smart Growth and Livable Communities. Translation paper #1, Second Edition, p.1.

If there is a single concept that captures what is happening and what needs to be done to make regional development strategies work for all, it is "making connections." Just as no single-focus program can by itself end poverty or retool a declining industry, no single sector of a region can effectively achieve development gains by itself. Integrating and coordinating the efforts of community organizations, city halls regional planning bodies and town/city/county officials will connect the regional agenda with those of inner cities. Linking economic development finance to workforce development and regional economic development will foster new, collaborative relationships, allowing state, regional and local policymakers to lay the groundwork for positive, long-term social and economic change.

Many DFIs are taking important roles in shaping the future of their regional economies. While these roles are usually led by financial transactions—through access to debt, equity or other financial products and services—they are increasingly complemented by a range of services that include data collection and analysis, workforce development and training, policy advocacy, and asset building and protection. It is these new connections and collaborations that offer fertile ground for identifying and investing in innovations that offer a more inclusive vision for regional economic development.

What follows are a variety of ideas to explore, critique, research, adapt and consider. Not every one is appropriate for every locale, but this paper seeks to expand the ways in which everyone, including DFIs, thinks about engaging in regional economic development.

Increasing Capital for Regional Development

Every economic development plan requires sufficient financial resources. DFIs have demonstrated their resourcefulness in capitalizing themselves. On a regional level, the capital needs are greater and will require creating or tapping new sources. In addition, fiscal constraints at all levels of government will demand even greater inventiveness and stewardship.

- ***Secondary markets***

In the U.S. financial system, well-developed secondary markets provide some economic sectors with an advantage in the competition for existing capital resources. In a secondary market, previously issued loans are sold to replenish the capital supply of the seller. With the growing prominence of institutional investors as suppliers of capital has come the increased importance of secondary markets. While the secondary market for residential mortgages in the U.S. is the best in the world, establishing criteria that would stabilize a secondary market in business loans is more difficult. A successful secondary market of business loans can amass huge pools of money that are potentially more stable and more patient than deposits, increase the liquidity of lenders, and raise the overall efficiency of the capital market. Financial innovators are in the earliest stages of demonstrating how to conduct these transactions at scale.

- ***Tapping pension funds***

Pension funds are one of the most patient and largest sources of capital for businesses, housing and other possible investments. Public and private pension funds amounted to $12 trillion in assets in 2005.[12] The governance and investment policies of a pension fund guide its investments in the company's own securities, international securities, stocks, bonds and real estate. Because they represent individual savings for retirement, pension funds have traditionally been managed rather conservatively, often concentrating their investments in low-risk, highly secure stocks and bonds. Regulatory changes in pension management coupled with more available capital and new global investment options have led to more diversified pension investments. In some states and localities in the U.S., small portions of public pension funds have been invested in private venture capital and other economically targeted investments, but these are not common. Because their stream of revenues are relatively stable, pension funds can have long-term investment time horizons, making them well-suited for economic development projects whose returns are not fully realized in the span of the average commercial loan.

Pension funds have been and continue to be invested in economic development activities. For years, a portion of union-based Taft-Hartley Funds has been invested in union-built real estate projects. CalPERS, the largest public pension fund in America, has committed over $2 billion for urban investment in California real estate and private equity ventures..[13] Belden Hull Daniels, a leader of the $3 billion double bottom line private equity industry, has worked on projects from South Florida to the Bay Area that invest in mixed use commercial, industrial, and mixed-income and workforce housing in urban infill and Brownfield cleanup sites.[14] More recently, the AFL-CIO announced plans to invest $700 million from its pension fund in housing construction, equity investment in commercial real estate and revitalization projects, among other uses, in New Orleans.[15] One way that public pensions could be tapped by DFIs at greater scale would be through a state public investment task force. Such a task force, created by DFIs in cooperation with other organizations or appointed by the governor, would be charged with developing prudent investment proposals that would help public pension funds earn competitive yields on investments while targeting those monies to strengthen sub-state regional economies. Composed of public employees, union leaders, investment bankers, pension beneficiaries, government officials, builders and public interest advocates, the task force would explore a variety of workable investment options, recommend other changes in tax and pension

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[12] Remarks Prepared for Delivery by U.S. Secretary of Labor Elaine L. Chao. "Protecting the Retirement Security of America 's Workers: The President's Plan for Reforming Private Defined Benefit Pension Plans." National Press Club, Washington , D.C., Monday, January 10, 2005. Accessed 4/26/06 at http://www.dol.gov/_sec/media/speeches/20050110_retirement.htm.

[13] Hebb, T. and L. Hagerman. (2005, October 25). "Best Practice in Pension Fund Urban Investments" in Meeting Notes from *Pension Funds and Urban Revitalization*, p.4. Retrieved on 5/25/06 from http://urban.ouce.ox.ac.uk/notes051025.pdf.

[14] Daniels, B.H. and D. La Franchi. (2005, October 25). "Double Bottom Line Investment Funds" a presentation at *Pension Funds and Urban Revitalization*, slide 3. Retrieved on 5/19/06 from http://urban.ouce.ox.ac.uk/events.html.

[15] "AFL-CIO to invest in recovery." (2006, June 14). *News and Observer*, p.2D.

laws and regulations, and develop guidelines to assure public employees that proposed investments will meet socially responsible criteria *and* earn competitive returns.

Another option to leverage pension monies for regional economic development would be the creation of a pension investment unit. This unit would broker in-state public and private pension fund investments in economic development activities like affordable housing. Like any broker, the unit would seek to match financing needs with sources of capital. It would package investment proposals for consideration by the investment staff and trustees of participating pension funds. In addition it would educate the public, elected officials, agency staff, pension fund boards, management and beneficiaries of the investment strategy.

- ***Expanding community reinvestment act coverage and disclosure requirements***

In 1977, Congress enacted the Community Reinvestment Act (CRA) to encourage depository institutions to meet the credit needs of the communities in which they operate. Expanding this community obligation to other financial sectors, such as commercial finance companies, mortgage banks, and investment banks would increase the availability of capital in underserved markets. These are significant and large holders of funds that could expand reinvestment appreciably. In addition to extending CRA requirements to more types of financial institutions, increasing disclosure requirements for all financial institutions, including depository intermediaries, will make small business lending activities more transparent. Information on the number and size of small business and farm loans and loan applications by race, sex, enterprise size and location would be especially helpful for investigating funding gaps or possible discrimination.[16]

- ***Curbing inefficient subsidies, creating effective ones***

Unless their tax systems are modernized, state and local governments will face greater fiscal constraints. This puts even more pressure on how the scarce economic development dollars are spent. While the stated aim of economic development often reads "to achieve a more widely shared and sustainable standard of living," as it is practiced by most states, economic development efforts often fail to achieve this standard. Too much money is spent on attracting businesses that offer temporary, low wage or low benefit jobs. DFIs can lead the call to redirect the massive amounts of money now being used for business attraction subsidies toward programs and policies that more effectively nurture homegrown businesses, equip workers with needed skills, and target low-income and distressed communities.

One example of turning tax incentives into a positive return for the entire region is the Massachusetts Capital Resource Company (MCRC). It was created nearly thirty years ago by the insurance industry in return for tax reductions on life insurance companies headquartered in the Bay State. The industry capitalized MCRC to provide subordinated financing to manufacturing, technology-based, and service companies. It also provides equity financing in

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[16] Seidman, K. (2004). *Economic Development Finance* (Thousand Oaks, CA: Sage Publications), p. 447.

amounts too small to attract venture capital and near equity for longer periods than typical mezzanine deals. MCRC's mission now includes community reinvestment deals. To date, it has invested about $400 million in over 200 businesses in 98 communities, resulting in the creation of 15,000 jobs. This state-led financial innovation brought about through regulatory change demonstrates that tax incentives can be leveraged to achieve wider economic benefits.[17]

Making Connections to Enhance Regional Collaboration

To meet today's complex economic and social challenges, public, nonprofit and private sector institutions engaged in economic development activities must be able to work collaboratively. Since the creation of regional governance structures to foster this type of collaboration is unlikely, new solutions must be explored. DFIs are in the position to lead these efforts with their strong ties to disadvantaged communities.

- ***Creating new regional alliances***

DFIs and other community and economic development policymakers and professionals could launch a fund that would support new regional alliances; a state could also do so by providing matching grants to groups that wish to form such regional alliances. These alliances could focus on urban revitalization, trade, asset-based anti-poverty initiatives, workforce development, technology, business modernization or entrepreneurship. DFIs could shape their own roles within the alliances. Synergistic ideas and energy as well as potential economies of scale are likely benefits of both the collaboration of DFIs with community and economic development professionals as well as the alliances themselves. While collaborations require careful management and skillful negotiation, the potential returns make exploring such options worth the effort.[18]

- ***Links with mainstream economic development professionals***

The economic development field is fragmented and involves all levels of government as well as private and nonprofit organizations. Its work is governed by countless policies and funded from numerous sources. Accurate figures on how much is spent annually on development programs and projects, nationally or otherwise, do not exist. Its activities include business attraction, incubation, and modernization; training; and affordable housing.

Development finance institutions are ideologically closer to CDCs, community developers and affordable housing agencies than they are to those practitioners and groups that attract firms, run visitation programs for existing businesses or upgrade the productivity of manufacturers. Because the more mainstream economic development practitioners know that they should be

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[17] Seidman,, p. 200; and http://www.masscapital.com/Overview/body_overview.htm (accessed on April 26, 2006).
[18] "Regionalism Today: Risks, Rewards and Unresolved Questions," by Curtis Johnson and Neal Peirce (January 2004) describes examples of different types of regional alliances ranging from city-county consolidation and the formation of regional governments to the "formation of ad hoc arrangements to accomplish regional goals" such as the Compact for a Sustainable Bay Area in California, Chicago's Metropolis 2020, and the Metropolitan Forum in St. Louis. The paper can be accessed at: http://citistates.com/Macpaper.html.

doing more for low-income individuals and communities, DFIs have the opportunity to engage them in progressive strategies. Most county-based economic development professionals have close and trusted relationships with existing companies; making business visitation programs an excellent source of referrals for potential deals. The Pennsylvania Steel Valley Authority's Strategic Early Warning Network (SEWN) includes both state and local economic development professionals with close ties to the management of local businesses. These relationships allow the network to provide a variety of supportive services to local employers in order to retain and strengthen key manufacturing industries and businesses.[19]

- ***Links with workforce development field***

Globalization and continued economic dislocation mean that there is a premium on workforce adaptability and an imperative for lifelong learning opportunities. Programs that link economic development finance with employment placement and training seek to ensure that economically disadvantaged workers have ample opportunities for employment. Several DFIs are already tying workforce development to their products and services; they encourage their clients to embrace workforce training and workplace management improvements.

- **The Reinvestment Fund (TRF), Philadelphia, PA:** TRF makes equity investments in companies with job growth potential for entry-level workers. It couples such investments with human resource assistance to raise productivity and maximize benefits to lower-income workers. It seeks to affect both the demand for and supply of labor using the tools of both capital provision and workforce development. In addition, TRF has played a leading role in assessing the regional workforce development system and designing new initiatives to fill crucial gaps in service delivery and performance.

- **Coastal Enterprises, Inc. (CEI), Wiscasset, ME:** Beginning in 1983, Coastal Enterprises, Inc. made its employment training agreement (ETAG) part of its loan closing documents. The ETAG requires the borrower to:

    - "Target a majority of new jobs created (depending on loan funds used) for low-income and minorities referred through Maine's job training programs;
    - Provide standard employee benefits package, including health care coverage;
    - Notify CEI of all new job openings as they become available;
    - Cooperate with CEI and job training providers in the hiring of people with low incomes and the implementation of the training program; and
    - Report monthly on employment and training activity."[20]

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[19] Lambe, W. and B. Schweke. (2006, forthcoming)., *Worker Dislocation: Some Promising Ways to Prevent, Adjust, and Recover* (Raleigh, NC: North Carolina Rural Economic Development Center, Inc. and CFED).

[20] Retrieved on 5/15/06 from CEI website http://www.ceimaine.org/content/view/95/141/ .

In addition, CEI has undertaken sector-based development and training initiatives; welfare-to-work efforts to access better paying manufacturing jobs; and the recent establishment of a subsidiary that provides transitional employment, temp-to-hire and job creation for people with disabilities, TANF recipients, refugees, immigrants, youth in foster care, and others with significant barriers to employment.

- **Sustainable Jobs Fund (SJF), Durham, NC**: SJF specializes in working with and financing companies that are committed to providing benefits, profit-sharing or employee ownership options, other employee-targeted asset building opportunities, workforce training, and good environmental practices.[21]

Another means of connecting workforce development and economic development is through first source hiring agreements. DFIs could take a prominent role in advocating that every business attraction subsidy require recipient firms to consider first a pool of applicants referred by local one-stop employment offices, nonprofit workforce intermediaries or community colleges. Companies are not required to hire these workers. Yet, such a scheme brings the business community and workforce organizations closer together and can be a means of hiring area residents, while sparking additional reform of the workforce preparation and retraining systems. Portland, Oregon, and Berkeley, California have successfully linked local economic development project finance to hiring agreements.

Place-based Development Strategies

Economic development is place-based with some areas performing well, while others lag in economic strength. DFIs can help create strategies that generate net new jobs, foster broadened business ownership and improve comparative advantage. Three distinct economic strategies are described below; in each, DFIs can encourage economic development efforts that benefit low-income workers.

- ***Increasing competitiveness***

Even the healthiest economies may need a boost. Competition strategies are focused on improving the comparative advantage of a state's regions and communities as well as moving a state's economic base toward higher value-added market niches. A critical component is increased labor productivity. High value products require skilled labor; skilled labor seeks jobs with higher pay, benefits, security and stability, decent working conditions, and opportunities for advancement and control. DFIs can use their power as financiers to acquaint their borrowers with the value of high skill, high performance workplace practices and management. These include quality circles, total quality management and job rotation. DFIs can also broker

[21] SJF Advisory Services, the non-profit, technical assistance wing of SJF, has produced a report called "Beyond Paycheck-to-Paycheck: Wealth Building Strategies for Venture Capital Funds to Use with Portfolio Companies and Their Employees" (2004) which is available at: http://www.sjfund.com/index.cfm?fuseaction=Page.viewPage&pageID=133.

technical assistance for their customers from the public or private sectors. There is a growing body of research evidence that these practices have positive effects on business performance.

In this way, DFIs could help stem the divergence between productivity and real earnings growth. Slogans for this might include “Share the gains of productivity,” “Reward worker excellence” and “Foster productivity from the bottom up.” For example, Vested for Growth (VfG), a fund operated by the New Hampshire Community Loan Fund that provides risk tolerant financing to New Hampshire businesses, believes that “engaging employees boosts productivity” and that “employees are engaged when the company allows them to ‘feel, think and act like owners.’”[22] To this end, VfG educates its portfolio companies about numerous strategies to engage their employees and works with companies to implement the ones that make the most sense for them.[23] VfG often offers incentives to portfolio companies to engage employees by offering a “good driver discount” that ties annual progress with management initiatives to a reduction in the cost of capital (often through a reduced percentage of royalty). This reinforces an important link between capital and mission outcomes.[24]

DFIs might also consider working on a clearinghouse of best practices in management strategies and employee asset sharing and development. The latter would include employee stock ownership plans (ESOPs), open book management, gain-sharing and profit-sharing. In partnership with private consultants, the clearinghouse might expand its scope beyond education to deliver training and technical assistance. The Ohio Employee Ownership Center (OEOC) at Kent State University already provides best practices research and technical assistance on ESOPs. Its research and best practices database could be leveraged or expanded in partnership with other organizations to include additional management and employee asset development strategies, and technical assistance providers as needed to serve other geographic regions.

DFIs could also develop a new line of business around ESOPs. In addition to financing ESOPs, DFIs could train board and staff and guide employees as they create their conversion plans. In addition to augmenting DFIs’ incomes, they would be increasing asset ownership among workers. Research conducted over the last two decades has found that ESOPs increase worker performance and often raise a company’s growth rates, profitability and productivity.[25] Employee ownership has also been associated with greater employment stability and higher rates of survival with no loss of efficiency. In fact, none of these studies found that this form of equity ownership harmed firms or hurt their performance.[26] Given the uneven track record of the few DFIs that have specialized in financing employee-owned firms, it would probably be

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[22] Retrieved on 5/15/06 from http://www.vestedforgrowth.com/about/corebelief1.html.
[23] Retrieved on 5/15/06 from http://www.vestedforgrowth.com/about/corebelief1.html.
[24] John Hamilton, Personal communication, 6/23/06.
[25] Rosen, C, J. Case, and M. Staubus. (2005). *Equity: Why employee ownership is good for business*. (Boston: Harvard Business School Press).
[26] Rosen, Case, Staubus, pp.105-115.

wise to leverage the expertise of effective efforts, such as OEOC and the National Center for Employee Ownership in exploring a range of options, from developing satellite operations and offices linked to OEOC, to encouraging efforts affiliated with leading ESOP consultants and manufacturing extension program offices.

- ***Restructuring after an economic shock***

Communities affected by economic restructuring, mass layoffs, downsizing, offshoring and shutdowns need to retain and modernize the remaining industrial base and to foster entrepreneurial initiative in order to recover from the negative economic shock. DFIs are well-positioned to lead these efforts since policy makers often focus their energies on helping the affected workforce become re-employed.

Plant closings or mass layoffs are symptoms of underlying conditions that need attention. Typically, they reflect an absence of economic dynamism, flexibility and resilience caused by an existing economic structure that is too narrow, highly specialized or dependent on a limited number of external markets. DFIs can help diversify the economic base by encouraging ventures in industrial sectors different from those already in operation. They can also orchestrate a comprehensive campaign that creates a more entrepreneurial culture. This can be done in a variety of ways: running education award loan programs in area schools; providing a range of different enterprise education approaches aimed at different types of individuals and enterprises across the region; capitalizing local seed capital funds and investor matching services; converting abandoned property to small business incubators or community work space; and giving more attention to existing industry via upgraded business visitation programs and more intensive business expansion and modernization services.

One organization engaged in this is the Westside Industrial Retention and Expansion Network (WIRE-Net) in Cleveland, Ohio. WIRE-Net is a membership-based, neighborhood-focused economic development entity that provides job training and referrals, workforce development services, industrial real estate services, and technology assistance to companies in Cleveland's west side community.[27] Created in January 2006, the Alliance for Illinois Manufacturing is a promising collaboration focused on helping northeast Illinois manufacturers become globally competitive. Business retention will be pursued "through the provision of technical and professional services delivered by its Illinois Department of Commerce & Economic Opportunity and City of Chicago funded business centers and grant programs."[28]

- ***Renewing chronically depressed areas***

DFIs have a long history in economically depressed communities. Because they understand the many challenges and issues affecting businesses and workers, they can foster a grassroots

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[27] More information on WIRE-net and other promising practices in place-based economic development can be found in Lambe and Schweke, (2006), op.cit..

[28] NORBIC. (2005, December 15). "Transforming Northeast Illinois Manufacturing: NORBIC joins partners in forming Alliance for Illinois Manufacturing. Accessed 5/22/06 from http://www.norbic.org/news/pr.php?pr=5.

economic renewal process. Designing a successful trickle-up strategy rests on DFIs' knowledge of the community and their ability to target tools at core economic weaknesses. A bottom-up renewal must be holistic. It must strengthen the interdependence of community members, physical facilities and space, political and social structures, and economic agents. Community institutions will need to work together to enhance individuals' employability as well as decrease social problems. While increased economic activity does not always lead to reduced crime (nor does decreased crime necessarily lead to increased prosperity), the twin problems of unemployment and crime make it much more difficult to start or grow businesses.

Above all, a healthy economy needs to provide its members with: 1) safety, security and social order; 2) neighborhood improvement and sanitation; 3) family support adjustment; 4) human capital development; 5) income generation; 6) property maintenance; 7) health; and 8) transportation. Community development and economic development should work hand-in-hand.[29] The presence of a DFI can stabilize an area by providing financial services, especially when depository institutions are adversely affected by local job losses and economic downturns. Too, it can be an anchor for other activities. DFIs can finance charter schools, affordable housing, energy efficient improvements, youth enterprise and other development-enhancing projects. The development finance field has a pivotal role to play in comprehensive community building and economic development efforts required to renew a chronically depressed region or community.

A bold proposition: system reform

While economic development has gone through many changes in the past three decades, some things remain the same, notably the continued reliance on attraction programs. Among the changes are adoptions of different approaches to cultivating homegrown economies. Federal, state and local governments have used technology transfer programs, microloan funds, manufacturing modernization, loan guarantees and direct loans in all shapes and sizes—targeted programs for providing management assistance to every conceivable type of entrepreneur in their efforts to nurture and grow small businesses. Together, these form a "system" in name only.[30]

On the whole, this system has done a lot of good, but it has created a great deal of clutter, confusion, fragmentation and waste. Some programs are well-managed and designed, others are not. Whole manuals are needed to describe all that's available for the average small firm. Many of the programs operate as quasi-monopolies and suffer from a lack of feedback on whether they are succeeding. Very few of them have the capacity to make a real difference for all of their potential customers, much less entire industries or the larger state economy. Neither

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[29] This framework was initially crafted by Cicero Wilson while at American Enterprise Institute. It was further adapted in Schweke, B. (1983, April). *Investing in Poor Communities*. (Washington, DC: CFED).
[30] Dubbed "The Third Wave" by CFED, various iterations and applications of it were hammered out by CFED staff, including Doug Ross, Bob Friedman, Brian Dabson, Bill Schweke, Mitch Horowitz, Joyce Klein, and Rick Carlisle.

individual programs nor the system as a whole are performance-driven or truly engaged in continuous improvement, despite the best of intentions. And because the services are often delivered by old-style bureaucracies, they are seldom integrated to make them user-friendly. In fact, business clients frequently dedicate staff to identify suitable programs and how to gain access. The proliferation of programs and organizations is perpetuated by the creation of new players to address new problems rather than using existing institutions.

Instead of adding to the loosely defined economic development "system," stepping back and reshaping the numerous, disconnected programs into a more accountable, cost effective system would increase the effectiveness of economic development work. This is a bold suggestion that requires assessing each program and its place in a seamless network designed to deliver services efficiently. Some programs will emerge intact; others will be reshaped (perhaps merged or taken over); still others will be dissolved. Quality data and analysis will be required to ensure that change brings improvement, not just political favor and/or institutional longevity. Government leadership in this is not necessary and may impair the effectiveness of the process.[31]

DFIs can be agents of system reform as respected players in the process. They can contribute to reform in three ways: as individual institutions, as the development finance industry and as members of the economic development field.

1. **Institutional strategies**. Individually, DFIs can strive to be exemplars, continuing to provide quality services to their customers and operating efficiently and sustainably (if not profitably). They need to adopt leading edge practices in capitalization, marketing, project identification, underwriting, investment servicing and monitoring, product pricing, dealing with delinquencies and defaults, and technical assistance for their clients. Pursuing these sound practices will increase the stature of DFIs and the development finance field.

2. **Industry approaches**. Collectively, DFIs need to reform their own industry. What's needed is an audit of the development capital market to identify existing gaps in type of financing available and in geographic distribution. Armed with that information, DFIs can assess the degree to which existing institutions match the needs of their customers. DFIs should also measure the effectiveness of their products, programs and themselves. In addition to surveying customer service satisfaction, DFIs should also capture the degree to which their borrowers are growing, expanding into new industries and markets, and increasing quality. Based on the audit and impact measurements, DFIs can make sure that they are offering the right kinds of capital on the right terms in a timely fashion.

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[31] John Hamilton, Personal communication 6/23/06.

3. **Systems reform**. DFIs can leverage their credibility and influence by advocating for systemic changes, such as private sector competition and re-engineering in the broader development field. The retooling of development finance will increase their credibility in suggesting that others take a hard look at they own operations and analyze their effectiveness in delivering development services.

- ***Private competition***

Can market forces help propel reform? One possibility is to provide small and mid-size businesses with a subsidy in the form of a voucher for technical assistance from the private sector. Entrepreneurs would be required to pay some portion of the private providers' fees but would have access to a range of private providers. By making more private alternatives accessible to more entrepreneurs, the vouchers would force public, nonprofit and quasi-governmental providers to offer quality services. The vouchers can be issued to a limited number of entrepreneurs initially and expanded if early recipients find them valuable.[32]

- ***Re-engineering delivery systems***

A concerted effort to achieve greater impact and excellence in the design and performance of economic development services and investments is the ultimate goal of this reform. One method of tackling such a large challenge is through the management strategy of re-engineering. What would a seamless economic development finance, management and service system look like? Integrated, transparent, effortless—these are characteristics that do not currently characterize economic development. Getting from its current form to a fluid, connected system of organizations will be neither fast nor easy. As with development finance's reform, inefficient, ineffective, outmoded institutions probably won't survive the process. The re-engineering will require political support, a thorough understanding of development finance and business services across the state, and bureaucratic and political savvy to succeed.

Research, Analysis, and Evaluation

There is no question that DFIs already play an important role in community and economic development efforts across the country. However, they have been unable to reach every market, community or region that needs a different strategy than the well-worn business recruitment plan. It is hoped that with more and better data and research in the following areas, DFIs and economic developers focused on economic growth that benefits low-income families will be able to show the superiority of this approach:

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[32] A pilot version of this idea was tested in Michigan by then Michigan Secretary of Commerce Doug Ross. A later example of the concept was crafted by CFED's Schweke and Carlisle for the Indiana Economic Development Council but never implemented. See: CFED, *Developing Small Business Programs in Indiana: The Need for a New Public-Private Approach.* August 1991.

- **Impact measures**. The impact of DFIs, including businesses and jobs created as well as income and revenues generated; this could build on work begun by the Aspen Institute and CFED.
- **Return on investment analyses**. Analyzing the return of economic development strategies such as business attraction programs and entrepreneurship so that comparisons on their cost effectiveness can guide future plans.
- **Cost/benefit analysis**. Pros and cons of direct intermediation, relative to guarantees, insurance, tax-based incentives for entrepreneurial-based investments, regulatory approaches, and so forth.
- **Small business performance.** Assessing the role of small businesses in job generation and stability, quality of jobs, training, invention and innovation, rate of return, and benefits.

Conclusion

While development finance is not a panacea, its institutions represent a critical resource in moving regional economic development forward. Capital should not be used to tackle issues that are really caused by a limited or shrinking market, an unprepared workforce, skill shortages, or management inadequacies. But it and its agents can be used to shape behavior and policy in ways that benefit communities widely and low-income workers specifically.

Given the war, rising energy and health care costs, and the likelihood of more tax cuts, every dollar must count. Capital problems caused by tax or regulatory policies must be corrected. Scarce funds for direct intervention must be conserved for use when they alone are the proper response to financial barriers that are needlessly hindering enterprise development and growth.

DFIs have the opportunity to shift American economic development policy away from expensive subsidies and toward investments that make businesses and workers agile and responsive. By changing the focus, building regional alliances, and continuing to put their traditional customers at the forefront of their work, DFIs will be an integral part of regional economic development. The tools that worked in the past are no longer the right ones to stimulate sustainable economic growth in this world of supply chain management, rapid product cycles, foreign industrial policies, mass layoffs and outsourcing.

While this paper has outlined multiple strategic options for DFIs to pursue, this should not be interpreted as an endorsement that individual DFIs should strive to meet all community and regional needs. In fact, the highest performing institutions select a few high impact strategies that leverage the organization's core competencies and other competitive advantages, and invest to achieve greater depth, rather than breadth of activities. DFIs must be alert to changing market conditions and the challenges and opportunities that they offer. To assume a more prominent role in development efforts, DFIs must continue to raise the caliber of their management, identify new sources of funds and put forth sound regional strategies.

Leadership and advocacy will increasingly matter as will running a tight ship. Expanding business asset ownership and fostering entrepreneurship and less uneven and inequitable development requires vision, persistence and collaboration. DFIs cannot drive the process alone, but the process cannot succeed without the creativity, support and resources of DFIs.

APPENDIX A: MEETING ON FINANCIAL INNOVATION AND REGIONAL ECONOMIC DEVELOPMENT

WASHINGTON, DC
OCTOBER 27-28, 2005

Summary recommendations

The participants in the convening represented organizations and institutions that have all taken leadership roles in reframing how nonprofit, public sector and private institutions can work individually and collaboratively to strengthen local and regional economies and ensure that low-income people truly benefit from these interventions and activities. In a day-long discussion of economic development finance, participants covered a broad range of topics. With the mandate to consider strategies that support and facilitate regional economic development that benefits low-income individuals, the highly animated discussion covered four main topics:

- Financing development finance;
- CDFI industry;
- Linking CDFIs and economic development; and
- Policy.

The recommendations listed below represent a diversity of approaches and strategies that are currently underway within specific DFIs or highly recommended by one of more of the participants in the convening.

Financing development finance

While the perennial question of whether there is a shortage of capital or a misallocation was unanswered, there was vigorous discussion about the pool of existing funds and its composition. Suggestions included:

- Identify permanent sources of liquidity; create a national liquidity facility.
- Syndicate subordinated debt.
- Have philanthropic organizations use a portion of their resources as guarantees to enable CDFIs to leverage more capital.
- Expand subsidies, including the New Markets Tax Credit.
    - New investors and players
    - Promote market-driven resources
- Expand guarantees and pre-development funds.
- Bring sources of capital together (market and subsidy).

In addition to increasing the pool of capital available to economic development, there were suggestions on how the existing pool can be better utilized:

- Conduct market analysis and needs assessment.
- Create a matrix of data sources on emerging markets.

- Include low-income people in developing strategies; talk with those who are impacted by programs to better design them.
- Combat “dumb” subsidies; i.e. minimize subsidies that benefit the wealthy and/or do not contribute to economic development.
- Provide alternatives and better target business subsidies through use of market analysis.

Development finance industry
Community development financial institutions (CDFIs) and the Opportunity Finance Network have become increasingly important players in the world of economic development over the last few decades. Participants made suggestions on how the industry can be strengthened, expanding its influence on the broader economy.

- Play to strengths. While tempting, expanding services for customers dilutes the effectiveness of CDFIs; other organizations already offer many of these better and at lower cost. As much as possible, CDFIs should be standardized, minimizing training and customization.
- Don’t innovate for innovation’s sake. To the extent that innovation expands the reach to customers and/or lowers costs, it should be pursued.
- Raise profile. Too few members of the public, including lawmakers, understand the importance of CDFIs. The industry must explain what it and its members do. It must research and report its impact, both quantitatively and qualitatively, and the ways it connects to low-income people. The use of stories resonates with many readers. It is especially important to package and communicate information on the industry to banks.
- Address regional economies by expanding the scope of local CDFIs (bottom up approach) as well as by using national CDFIs to focus on smaller geographic areas (top down).
- Create new collaborative structures and networks through which infrastructure, information, technology and learning can be shared at a regional level. Use Internet resources more effectively (e.g.—blogs).
- Subsidize CARS, the rating system for CDFIs.
- Address discriminatory elements of credit scoring.
- Research other drivers of profitability than interest rate spread.
- Educate borrowers to increase their credit-worthiness.
- Identify, foster and mentor regional leaders.
- Apply the “community tool box” or “executive on loan” idea to CDFIs.
- Build capacity of CDFIs to respond to local markets with risk-tolerant capital.
- Regional entities should work in collaboration with smaller, more local entities.
- De-emphasize the word “scale.”

Linking CDFIs and economic development
- Provide alternatives to business incentives (related to minimizing “dumb” subsidies above).
- Assess and address economic and environmental impacts.

- Bring labor, education, and consumers to table to talk about regional economic development.
- Expand economic development training (distance learning?).
- Link rural and urban strategies.
- Research trends in workforce development and transitional employment models.

Policy

The development finance industry is strong and growing. Yet, its reach would be greatly enhanced by sound public policies. Toward that end, participants strongly endorsed:

- Securing funding for policy work.
- Setting out a bold, progressive policy agenda.
    - Alternatives to business subsidies
    - Minimizing subsidies to the rich
    - Use existing resources better
- Identify legislative champions (engage Republican leaders or those who influence them).

Other ideas worthy of mention include:

- Creation of an Innovation bank.
- Intersection of finance and HR services.
- Disseminating this meeting's work widely and in easily digestible form.
- Engaging all regions of U.S. (moving focus away from the northeast).