Financing Economic Development in the 21st Century

Edited by
Sammis B. White, Richard D. Bingham,
and Edward W. Hill

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Overview

Communities across the country seek secure financial futures. But seeking and achieving may be two different things. The national and international economies march to their own drummers. Local municipal entities do not have control over their own economic fates. They must adjust to the changing larger economies. Sometimes areas win big, as did Pittsburgh with the growth of steel or the Silicon Valley with the growth of computers. But as Pittsburgh has also shown, there are downturns as well. Economies that had been growing begin shrinking. Such communities are challenged to find ways to strengthen themselves. Other communities may be slow to grow, and they also must find ways to ensure a more secure future.

A critical ingredient for economic growth is capital. That is the central point of a capitalist economy. Fortunately, in the United States, we have developed a wide variety of tools to fund business activity. We rely heavily on such traditional financial institutions as banks. But we have also developed many innovative ways to reach portions of the market that are not served well by traditional financial institutions. New firms, for example, are not as likely to receive loans from banks as are established businesses. Businesses in specific areas, such as inner cities or rural communities, have a more difficult time convincing traditional sources that they are reasonable firms to which to make loans.

Additionally, communities compete with one another for development. Unless they have revenue sharing agreements, neighboring communities seek to enlarge their own economic base. They want to do so with the least possible expenditure on their part. So they develop tools that appear to have little or no cost to their community, tools such as tax incremental finance districts, impact fees, developer donations, and the like. The idea is to promote development, but not at the expense of existing residents and businesses.

The federal government also has a hand in this. A periodic federal government goal is to improve equity in the nation by increasing the employment opportunities for those with few opportunities. The federal government for the past forty years has tried several initiatives to expand job opportunities in low-income areas. In recent years, the federal government has created special zones in which employers are offered incentives to locate and to hire workers who have few opportunities.

Communities also face a number of special situations in which they might have to provide capital in order to stimulate development. For example, communities may have previously used land that is environmentally contaminated. With current laws placing financial responsibility on any owner, such lands are difficult to get developed. But for communities with little open space, such lands are the future. Creative mechanisms need to be developed to attract investments. Similarly, communities are being pressed to enhance themselves with sports stadiums of various sorts. Not all communities do so, but the pressure is there to put public dollars into such developments, even in communities that have resisted subsidizing other forms of economic development.

Public subsidies are not the only solution. In fact, subsidies are but a small part of the solution. The answer in most situations is private capital. More and more communities are realizing the important role that "risk capital," as opposed to the more conservative bank capital, plays in developing new businesses. The more of such risk capital that can be attracted to ventures in a community, the greater the community's chances of generating viable new businesses that will grow in the future. Communities need to learn about "angel financing" and "venture capital." Communities must do what they can to ensure that such sources are available locally and that there is a demand for such moneys (i.e., businesses are being started and grown).

For individuals who are interested in economic development and what makes it work, knowledge of alternative means of financing is critical. This volume is intended as an introduction to many of the more viable forms of finance available for economic development. The chapters cover a wide range, from angel finance to revolving loan funds to tax incentives to various developer payment schemes. The methods cover public, private, and combined techniques. The options vary from ways to force developers to pay to methods to publicly underwrite new economic activity. The alternatives may be utilized by municipalities, the state, or even the federal government, but most are local. The alternatives covered are those that we think are most likely to be employed in the foreseeable future. These are the techniques that have stood the test of time or have a history that should be recognized.

Economic development finance has become much more sophisticated than it was fifteen years ago. Many of the methods that were tried then have been refined or eliminated. A few, such as tax increment finance, venture capital, and business angels, have been expanded upon and used even more widely. Others such as industrial revenue bonds and export financing have largely disappeared from the landscape. This new volume introduces readers to a number of finance techniques and to some of the formal assessments of the variety of alternatives that have been employed to promote economic development. The featured techniques are likely to be in use for the foreseeable future, given their success to date.

The book may be read cover to cover, or individual chapters can be used in any order desired. The intent is to inform the reader of the basics of the options and to review what is known about how well many of the financing options work.

Introduction

Before looking at alternative ways to fund development, it is important to obtain an understanding of what it is that communities are seeking to achieve and how legally they are able to operate. The first chapter, by Stephen Malpezzi, starts by defining economic development. He goes on to discuss various goals of economic development that communities might seek. Examples include more employment, higher property values, and higher per capita income. Fortunately, these often occur together. But they are not exclusive, and they imply somewhat different paths of development.

Malpezzi then takes a cursory look at what factors are thought to be responsible for development, in addition to capital and public incentives. But his real focus is the special role of finance in the economy. He discusses many forms of finance. He talks of numerous efforts by the public sector to supplement the forms available in the private sector. He introduces the many topics that are covered by the subsequent chapters.

Ferdinand (Andy) Schoettle sets the legal stage for public intervention in financing economic development. Government involvement came early in the United States. Opened in 1825, the Erie Canal was dug with money from bonds floated by the state of New York. The effort was so successful that other states and municipalities decided it was an approach they should also try. Unfortunately, few enterprises were as successful as the Erie Canal. Municipal and state budgets were greatly strained by their ill-conceived investments. The result was the enactment of strict limits on such endeavors.

But those limits did not stop communities from creating alternative ways to attempt to stimulate development. The issue is what is legal and why. This chapter discusses some of the enabling laws and some of the limits that have developed over time and sets the stage for many of the subsequent chapters.

The Developer Pays

Communities want development to occur. In the middle of the twentieth century there were many examples of communities that generated development by investing their own money in such development stimulants as infrastructure. If a developer would propose building a 200-unit residential subdivision or an industrial park, the community would commit to building the streets and supplying the water and sewer infrastructure. Such an aggressive approach has largely been abandoned because it proved to be too expensive to the community. In fact, the tables have almost completely turned—developers must now agree to pave the streets and put in the local infrastructure for sewer and water before they even begin to get approval for a proposed project.

The next three chapters discuss various elements of economic development finance in the new world for developers. The chapter by Rachel Weber discusses a very popular technique for funding the construction of infrastructure for development. The technique is called tax incremental financing (TIF). It is a technique that involves the individual municipality putting in some or all of the infrastructure for a development, as an incentive to attract that development. Although the municipality pays for the development up front through the sale of bonds, it is the purchasers of the parcels that pay in the long run. All of the increment in property taxes above and beyond what was paid before development occurs is channeled to pay off the bonds for the infrastructure. Once the bonds are paid off, then the additional tax revenue goes into the community's general fund. The community does not pay directly, nor does the developer. But by putting in the infrastructure up front, the community is able to stimulate development that might not have otherwise occurred. That is its appeal. TIFs are not without flaws; Weber discusses some of these and suggests improvements that might help them to be even more successful as an economic development technique.

The chapter by Larry Ledebur and Douglas Woodward talks of modification to public funding techniques that can be employed to the benefit of a community. In some cases, communities decide that they must invest some of their own money to stimulate development. Each time a community does so, it is taking a chance that such development might not repay the community what it has invested, much less pay a return on that investment. After several high visibility situations in which companies received financial inducements to locate to specific communities and then left after having accepted the money, communities began to wise up. Communities still offer financial incentives, but instead of just suffering if the company does not stay or does not create as many jobs as promised, communities can get tough. They can create what have come to be known as "recapture agreements," ways to retrieve money from companies that have not kept their promises. Recapture agreements are prevalent in Europe and just beginning to gain acceptance here.

These recapture agreements cover a range of situations. Sometimes companies do not get a free ride; they get a repayable inducement to do business in a given community. Such inducements are termed "clawbacks." Another term is a "recision" agreement, one that allows for cancellation of a subsidy agreement, should certain specific conditions not be met. In other instances penalties can be charged to firms for not performing in the manner specified or for moving before an agreement expires. Yet another modification is termed a "recalibration." This applies in situations where a subsidy agreement is adjusted over time in response to changing business conditions. In each situation communities are not committed to a certain subsidy and then left out to dry. This chapter discusses the many issues related to such recapture agreements. The various agreements have yet to be universally used. But the case is made that they should be to better protect the communities offering subsidies.

The third chapter in this section is about another way to extract concessions from developers that want to develop in a given community. Unlike the recapture agreements that apply to communities that have given subsidies to attract development, development exactions apply to developers that want entrée to a community and the community wants to avoid some of the costs associated with that development. Michael Peddle and Roger Dahlstrom discuss many alternative ways to get the developer and ultimately the developed property owner to pay for some of the costs that development generates for a community. Examples include such techniques as impact fees; developer donations; in-kind developer provision of services; and developer-constructed, off-site infrastructure. The chapter explores these options and discusses some of the places where each might be more appropriate. In addition, it looks at what might be the costs of attempting to use such techniques on developers.

Public Financing

For at least the past thirty years in the United States, communities, sometimes with the help of the federal government, have developed various ways to try to induce new development to occur within their boundaries. Several of the methods employed have involved subsidies. Subsidies have sometimes been direct cash grants. Other times they have involved the government provision of services that otherwise would have cost the developer additional money. In still other instances, they have involved property tax reductions or income tax reductions or credits. Subsidies may also involve reduced fees, free employee training, or several other ways to reduce the private sector costs of locating in a specific community.

The big question for all communities and for the U.S. government is to what degree these various forms of subsidization have actually helped to bring about the desired development. Several chapters in this section explore specific types of subsidy programs and assess the degree to which the subsidies have succeeded in stimulating the types and scale of development intended.

Alan Peters and Peter Fisher are experts on a federally led program known as enterprise zones. These are specially designated geographic areas in which firms can earn tax credits or other forms of tax reductions for locating and adding specified types of employees. The idea behind them is the inducement of new development in a specified territory and the hiring of specific, low-income employees. The federal zones have been duplicated by many states and even some cities. The big question is whether this approach actually works. Peters and Fisher review the fairly extensive literature on that issue and report on their own extensive efforts to answer the question.

Rod Hissong goes even further to review a number of different approaches to inducing economic development. He discusses enterprise zones, but he goes beyond to explore the literature on several alternatives. He criticizes not only the specific mechanisms, but also the means of evaluating the mechanisms. He suggests alternative means of evaluation and discusses some superior examples.

Donald Schunk and Douglas Woodward report on their recent assessment of state incentives in the context of overall state economic development, using BMW's location in South Carolina as a case study. It is the first published, comprehensive case study of the impact of industrial incentives. The authors make the explicit attempt to link economic development incentives and a variety of outcomes. They make the case that, when properly designed and executed, economic development incentives can attract significant capital investment, create jobs, and promote regional restructuring. They also suggest that these aims are not always, nor necessarily often, achieved.

The next two chapters take a different tack. They explore in some detail two public means of stimulating development. Kelly Robinson examines publicly funded revolving loan funds. These are entities that take the original capital, lend it out, and then make additional loans to new firms as the original set of loans is repaid. The appeal is that loans can be targeted to firms with specific characteristics and that the money continues to circulate among those types of firms. Such loans are usually made to firms that may not be able to get bank financing or as much bank financing as they think they need to succeed. Thus, the public sector is helping to meet a need and bring about additional development.

Beverly McLean and James Bates explore an approach to development that is the result of years of learning from mistakes. They examine a refined way of collaborating to finance neighborhood business revitalization. They review the many barriers to neighborhood business development, examine the strengths and weaknesses of private sector financing tools for this purpose, and then provide some examples of successful collaborative efforts to revitalize neighborhood businesses. They see a role for public sector financial involvement.

Special Situations

General finance techniques can work in many situations to promote economic development. But in some instances the usual may not be enough or it may not be appropriate. The chapters in this section examine what we think are special situations, instances in which the more common forms of economic development finance might not be sufficient.

The first chapter of the section deals with a very high visibility mechanism that many communities have selected as a means of economic development—sports facilities. Ziona Austrian and Mark Rosentraub review the recent wave of largely public investment in sports facilities. Communities look to this investment to generate construction jobs, skyline enhancement, entertainment employment, and a psyche boost for the community. Sports franchise owners often convince local politicians that they will betray the public trust if they do not commit public financing to keep the "symbol" of being a "major league city" in the community by constructing a new facility. But is this a wise public investment? Austrian and Rosentraub review the expanding literature that assesses the evidence on this question. They cite the few instances in which private owners have stepped up and made the investment themselves, as they did before the latest round of facility construction. And they explore the many, and sometimes unique, ways that communities have employed to come up with the dollars needed to pay for these expensive facilities.

The second chapter of special situations is quite different. The topic is brownfields—environmentally contaminated land or buildings that have proved to be difficult to reuse because of the liability for cleanup involved. These sites have economic potential from the private perspective because some exceptional profits can be made if the sites can be reused. From the public sector viewpoint, the sites hold potential as an additional tax base and as the location of many new jobs. The difficulty is that reclamation is thought to be very expensive and the results are not assured. Private developers have been slow to step into these situations, preferring to put their money and time into safer "greenfield" development.

To stimulate brownfield redevelopment, the public sector often has to step forward in order to reduce perceived risk. Local, state, and federal governments have created a variety of techniques, often financial subsidies, to convince private investors to get involved with brownfields. Peter Meyer and Kristen Yount review the problems and many of the finance schemes that have been created to address brownfield redevelopment. Progress has been made on this topic, but much remains to be done.

The third chapter in this section covers a quite different situation, that of retail. Unlike help for manufacturing, which can be easily justified because manufacturing is thought to be a "base" industry that brings in money from outside the local economy, retail seldom plays this role. The Mall of America in Bloomington, Minnesota, is an exception. Most retail serves a largely local audience. Providing a public subsidy to encourage most forms of retail development is harder, because what a subsidy does is modestly change the location of that activity. William Bowen, Kimberly Winson-Geideman, and Robert Simons explore the difficult subject of public investment in retail development.

The authors explore the rationale for public involvement. They try to find situations in which public investment can be justified. That is not an easy task. Having explored possible situations, they go on to examine the variety of tools available for the task and discuss several examples where each has been used. They finish by exploring a special situation in which public investment might be justified more easily—the assisting of retail for equity reasons, mainly attempts to serve underserved, low-income neighborhoods.

The fourth chapter in the section is also quite different. It focuses on rural development. Rural development is very different from urban development because the scale of development and densities are much smaller. Rural areas have been declining for over a century, yet almost one-quarter of all Americans live in places designated as rural by the Census Bureau. The difficulty is that this 25 percent of the population is spread over the vast majority of the landscape. Most rural areas are limited in terms of financial capital, human capital, and natural resources beyond vast acreage. Development does not occur as naturally as in urban areas.

Rural economic development is more likely than urban development to need partnerships. The risk is greater, as are the hurdles, such as lack of capital, absence of economies of scale, few entrepreneurial networks, and an independent spirit among rural populations. These hurdles can be lowered through policy and effort. That is the charge. Economic development finance has a role, and John Magill reviews many of the ways in which economic development is being undertaken. Readers will find many acronyms for government programs that have been used in rural economic development. These programs appear to be the needed ingredient to stimulate more rural development.

Private Finance

In a variety of situations public finance in different guises is used to stimulate private investment. But what is clear is that it is private finance that drives development. Certainly, in specific situations a good case has been made for various forms of public intervention. However, most of the investment in local economies comes from private sources of capital, especially for new business formation. The last section of the book contains three chapters that cover three of the most important sources of private capital for new business formation and growth.

Timothy Bates examines the use of bank credit for small businesses. A common misperception is that new business owners do not have access to bank loans. Bates contradicts this "myth" and contends that over 50 percent of the startup funding to launch new businesses comes from borrowings, mainly from banks. As the new firms mature, they rely increasingly on banks for financing. This is not to say that assembling sufficient capital is easy; it is not. The chapter explores the degree to which barriers to funding small businesses exist and for whom the barriers are larger. Bates also explores some means of overcoming those barriers.

For some new businesses, those thought to have high-growth potential, a highly sought source of capital is the "business angel." Business angels are individuals with substantial net worth who invest in startup and early stage businesses. These wealthy individuals have the wherewithal to absorb losses if a firm does not succeed to the degree initially imagined. The angels can and often do invest in several new startups concurrently, hoping that at least one will "hit the home run" and return many times the original investment. The firms they choose to support are thought to have the potential to grow much more rapidly than the norm. Such firms are often called "gazelles" because they jump so far into the lead. Angels commonly provide not just capital but seasoned business advice to help the firms succeed. Fortunately for the U.S. economy, the number of business angels grew rapidly in the 1990s as numerous business enterprises flourished.

Adam Bock discusses many aspects of angel finance, from the perspectives of both the angel and the individual seeking angel finance. This chapter is a comprehensive look at angel financing, and it contains a wealth of information for all who may be involved in the activity. Bock actually runs two angel-finance networks, organizations that pool business angel money and interests. Angel networks are a recent development that has added efficiency to the search for angel money. New firm owners can now reach thirty or more potential investors by making a pitch to one network, and angels can listen to a limited number of prescreened pitches to seek the firms in which they care to invest. The chapter is a mini-handbook on the subject of business angels.

The final chapter is a similar handbook, but it covers a more specialized commodity, venture capital. Venture capital is invested in even fewer firms than angel finance. At its high point in 2001, venture capitalists invested over $210 billion in new enterprises. That is a staggering figure and speaks to its importance. But venture capital is reserved for those firms that appear to have the best chance of succeeding past the initial business angel or other informal financing rounds. In recent years the bulk of these venture capital funds has gone to high-tech firms. But that pattern is likely to change a bit as the high-tech sector loses its luster and enormous expectations.

David Arnstein, a venture capitalist, gives the reader a host of insights into this oft-mentioned form of capital. The chapter explores just what venture capital is, to whom it is most likely to go, and the various stages of firm growth and finance needs. He goes on to discuss current industry preferences and the history of venture capital. He then explores the details of how one goes about obtaining venture capital and how venture capitalists operate. The details offer insights to anyone who wants to be involved in any role in the venture capital process.

Contents

List of Tables and Figures

Tables

Figures