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Financial Market Intervention as a Rural Development Strategy

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Abstract

The Federal Government is involved in rural financial markets in a number of ways to ensure the safety and soundness of the financial services delivery system, to correct private financial market failures, and to further a variety of policy objectives that are only coincidentally related to rural financial markets themselves. This report is concerned with the usefulness of Federal intervention in rural financial markets as a mechanism for fostering rural development. The chapters in this report describe the financial system serving rural America, assess the adequacy of this system at meeting the financial needs of rural businesses and governments, and examine the effectiveness of previous Federal "credit" programs of special concern to rural America.

Keywords: Rural development, rural financial markets, government credit programs, rural business, rural governments, rural development policy

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Foreword

This report examines governmental intervention in financial markets as a strategy to promote rural economic development. It is the first of several reports on the effectiveness of selected strategies that governments can use to stimulate such development. The other reports deal with education and training, funding for public infrastructure, and private business investment as rural economic development strategies.

Each report in this series contains chapters exploring various aspects of one broadly defined rural development strategy. They review previous social science research and present new analysis. They do not evaluate specific programs. Rather, the objective of the series is to describe the probable consequences of adopting a broad approach, including its effectiveness, limitations, and incidental effects.

These reports are intended to support policymakers with timely economic analysis of rural issues. Like *Rural Economic Development in the 1980's: Prospects for the Future* (RDRR-69), the comprehensive collection of studies on rural conditions and economic characteristics published in 1988, this report reflects ERS's efforts to sharpen the focus of its research and make it more useful and accessible to policymakers and their staffs.

Important rural policy issues are now on the agendas of the Executive Branch and Congress. The President's Economic Policy Council and the Secretary of Agriculture have expressed strong interest in rural development. The President has issued a rural policy statement, and the Secretary has begun a review of USDA's rural mission, aimed at sharpening the Department's focus. In Congress, rural development bills, very different in form and content, have passed the Senate and the House of Representatives. Rural development has also been linked by the foreign ministers of the world's developed nations with success in the Uruguay Round of negotiations on the General Agreement on Tariffs and Trade. In these negotiations the main participants have agreed, in principle, to seek to reduce agricultural protection, considered by most countries as the chief form of governmental assistance to rural people. Finding a new and better way to help rural areas develop economic opportunities for their people is regarded by some as a necessary precondition to giving up agricultural protection.

The poor performance of the U.S. rural economy during most of the 1980's lies behind much of the current policy concern in this country, and similar trends are apparent in other developed countries. Following a historically unprecedented rural renaissance in the 1970's, most of America's rural areas were hit hard and recovered slowly from the 1980-82 recessions. Although there is evidence of an upturn in the last few years, the 1980's were dismal for most rural areas by virtually every measure. Rural per capita income declined in real terms and in relation to urban per capita income. New jobs were created at a much slower pace and real earnings per job declined absolutely. Unemployment rates rose faster and higher and stayed at recessionary levels longer. At one point in the decade, the poverty rate was 35 percent greater than in metro areas. And more than half the Nation's rural counties lost population in the 1980's.

Rural development goals are numerous and diverse. They include reducing the gap in incomes and standards of living between rural and urban people, helping to stabilize or improve the economic prospects of threatened rural communities, attacking extensive and persistent poverty in certain rural areas, preserving the rural character of some areas, helping the family farm survive, contributing to overall national economic well-being, and conserving natural resources and the environment.

Some of these goals are independent, some mutually reinforcing. But in practice, progress toward one goal often seems to come at the expense of others. Examples are numerous. Farmers' average real incomes rose over the last decades, to the point that they are actually higher than other rural people's incomes and close to the national average, but so many people left farming that fewer people share the sector's earnings. The structural changes that increased average farm income--fewer, larger farms--were unwelcome to those who prefer a sector made up of small farms. The same changes in the sector also threatened the economic health of many farm-dependent rural communities. New employment opportunities that make a rural community more vital sometimes create environmentally damaging and aesthetically displeasing sprawl. And new jobs that broaden a community's economic base may worsen urban-rural income disparities if they pay low wages. Unless the poor share in the job growth, which many cannot in rural areas because of age or physical disability, development will not reduce poverty.

Almost any strategy will succeed by some criteria and fail by others. Analysis that does not measure a strategy against a specified set of key goals may identify many benefits but not contribute much to the policymaker's search for best means of achieving the broader purposes. Therefore, we have chosen, in effect, to define rural economic development by what seem to us its two broadest and most widely held goals: raising rural incomes toward the national average and helping preserve threatened rural communities.

Acknowledgments

Many people, in addition to the authors, contributed to this report and others in the series. A committee chaired by Richard Long, and made up of Herman Bluestone, Thomas Hady, Sara Mazie, David McGranahan, Katherine Reichelderfer, Norman Reid, and Patrick Sullivan planned the series. Patrick Sullivan guided and coordinated the preparation of this report. David McGranahan, Norman Reid, and David Sears performed similar work for other reports in the series. Lindsay Mann provided editorial guidance, and Joseph Lockley provided production assistance for the entire series.

Although final responsibility for the contents rests with the authors, like most research in the Agriculture and Rural Economy Division of the Economic Research Service, many of the concepts and some of the analysis used in this series are drawn from a base built by colleagues. That base is too interwoven and has been created by too many researchers over too long a period to allow full recognition for each contribution. Most notable in that group, however, is Kenneth Deavers, Director of the Division, who has guided the ERS rural development research program intellectually, as well as administratively, for many years.

Richard W. Long
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Contents

Summary

The availability of affordable financial capital has long been recognized as an important factor in economic growth and development. An efficient financial market is not sufficient to ensure that economic development will occur, but its absence can retard even the most serious efforts to spur development. For this reason, financial assistance, in one form or another, is often at the heart of rural development initiatives at all levels of government. This report examines the basis for government intervention in financial markets for the purpose of furthering society's rural economic development goals.

Rural Financial Markets

Rural financial markets are more complex, diverse, and dynamic than the stereotypical view of the one-bank town would lead us to believe. Rural financial services are provided by a wide variety of private, for-profit enterprises, nonprofit organizations, and governmental agencies. Still, for most rural business and government credit needs, commercial banks remain the prime source of funding. Depending on State law, the commercial banks serving rural markets can range from branches or affiliates of large, international banking organizations to small, independently owned, single-office banks. Each type of bank has strengths and weaknesses as a source of funds for rural economic development.

The financial landscape continues to change rapidly at the national level, but to date these changes have generally not adversely affected rural financial markets. Rural community banks continue to survive and serve local credit needs, even when competing directly with large bank organizations. And the influx of larger financial institutions into rural markets often brings new financial services and the increased ability to handle large, complex financing requests.

Business Access to Capital

The available evidence suggests that the vast majority of rural nonfarm businesses are satisfied with their financial service providers, particularly for short- and medium-term credit. However, certain types of firms in certain markets probably experience difficulty acquiring capital for reasons unrelated to creditworthiness. Small firms in markets served by large banks, and large firms in markets served by small banks are often dissatisfied with their local financial institutions. Firms involved in unfamiliar technologies or product lines and those in the region's dominant industry experience relatively high

loan denial rates. Newly starting firms and rapidly expanding firms have more problems acquiring financing than do stable, well-established firms.

To the extent that they exist, rural capital market problems appear to be a function of inadequate skills in developing business plans and financing requests within the rural business community and of the inability or unwillingness of rural capital providers to accurately assess and diversify risk. Governmental policies which improve the flow of information between businesses and prospective capital providers, or that increase rural institutional usage of more sophisticated, complex financing schemes may help alleviate these problems.

Local Government Access to Capital

Local governments play a dual role in the development of rural economies. They provide basic public services and infrastructure to rural residents and businesses and they provide additional assistance to new and expanding rural firms. Most rural development strategies involve increased local government spending for education, training, infrastructure, or business assistance. As a result, the success of many Federal and State rural development initiatives depends, to a large extent, on the ability of rural governments to acquire affordable financing. But their small size, narrow tax bases, high tax burdens, and limited access to capital markets leave many rural governments with insufficient funds for development initiatives.

Local governments can take steps to lower costs, diversify their tax bases, and bolster their development prospects, but the available options are limited. Furthermore, without assistance from higher levels of government, the limited staffs of most rural governments and their lack of expertise and leadership, often slow needed change. Both the Federal and State Governments can help by providing technical assistance, easing regulations which add to the costs of locally financed projects, increasing rural government access to capital markets, and providing targeted financial assistance.

Federal Rural Development Programs

Financial assistance has historically been the primary vehicle used to further the Federal Government's rural development objectives. Grants, direct loans, and tax preferences have been important in the past. But, continuing budget deficits, improving financial market operations, and changing political beliefs led to the adoption of strategies in the 1980's that provide support by encouraging private lenders to supply the needed funds. As a result, current rural development finance proposals rely heavily on loan guarantees, Government-sponsored secondary loan markets, and revolving loan funds.

For business finance, where the objective is to improve the efficiency of financial markets by improving creditworthy rural firms' access to credit, current Federal credit proposals should help. But for rural infrastructure finance, the public-good nature of local government activities allows for a larger, more direct role by the Federal Government. Increasingly stringent Federal environmental quality and safety standards are placing a major burden on small communities. To ensure that Federal mandates are fairly carried out, Federal grant and subsidized loan programs may be justified for fiscally stressed rural communities.

Financial Market Intervention

The Federal and State Governments are heavily involved in the operations of financial institutions and markets for a number of reasons. Chief among these is to ensure the safety and soundness of the financial services delivery system. But governments are involved in financial markets for other reasons as well. Within the rural development context, concerns over the way financial markets allocate capital have led to government intervention. Government programs attempt to improve the efficiency of private sector markets (by correcting financial market failures or adjusting for nonfinancial market failures) and redistribute employment opportunities, income, and public services to more closely meet society's concept of what is "fair."

Loan guarantees, secondary markets, revolving loan funds, and technical assistance can help improve the efficiency of financial market operations. But for society's concerns over the distribution of economic resources or nonfinancial market failures, grants and direct loan programs remain more effective financial remedies. Government intervention in financial markets is meant to reduce the cost of capital or increase its availability. Even if successful, such steps will result in additional development only if investment opportunities become economically attractive as a result. If no such opportunities exist, or if other obstacles prevent their coming to fruition, then government intervention in financial markets will ultimately be ineffective at stimulating rural economic development.

Chapter 1

Financial Market Intervention as a Rural Development Strategy: An Overview

Patrick J. Sullivan*

Introduction

The availability of affordable financial capital has long been recognized as an important factor in economic growth and development. Many firms and governments rely on borrowed funds to help finance their daily operations, and few have the resources to finance significant expansion of their capital solely with current revenues and retained earnings. With adequate financing, businesses and governments can adjust to market and technological developments in ways that improve the productivity of local resources. If external funding is not available, or is available only at prohibitively high costs, investment in productive capital and infrastructure might have to be postponed or canceled, depressing the area's future economic growth. Access to debt and equity capital markets is, therefore, necessary for sustained economic development within modern economies.

But the importance of financial markets in the rural economic development process can be easily overstated. Access to efficient financial markets aids development, but it is not sufficient to ensure that economic development will occur. Other factors--such as a lack of skilled labor, distance from markets, or the limited capacity of the public and private institutions needed to support economic growth--can erect barriers to growth that an efficient financial market cannot overcome.

Nonetheless, rural development protagonists often assume that lagging economic growth must be tied, at least in part, to failures in the rural financial services delivery process. Thus, various Federal and State programs

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have been adopted over the years to ease the flow of credit to rural businesses and governments. New rural development legislation should reflect a balanced assessment of the rationale for governmental involvement in financial markets and how best to attain our rural development objectives.

This report explores how adequately rural capital markets serve the financial needs of rural governments, businesses, and prospective entrepreneurs, with the aim of determining what role, if any, the Federal Government should play in the financial services delivery process.

This chapter provides a broad overview of the issues involved, describes the economic rationale for government intervention in rural capital markets, and summarizes the major findings of the four other chapters. Chapter 2 describes the rural financial delivery system in detail and how this system has evolved in the face of recently changing technological, market, and regulatory forces. Chapter 3 summarizes the available evidence on rural business access to debt and equity capital. Drawing largely on their work in rural Wisconsin, the authors describe what has been learned about the local capital markets that most rural businesses face and how successful rural businesses at various stages of development have been at securing financing. Chapter 4 assesses how well financial markets and intergovernmental assistance programs are serving the needs of rural governments. Chapter 5 examines Federal programs aimed at easing rural business and government access to financial capital.

These chapters describe much of what is currently known about the workings of a complex, dynamic system of public and private institutions serving the financial needs of rural America. While decisive evidence is rare, the general conclusion is that today's capital markets are doing an adequate job of serving the financial needs of most rural businesses and governments. Nonetheless, the absence of convincing evidence of widespread rural capital market failure does not mean that markets are working perfectly or that the government has no role to play in the financial services delivery process. Past research suggests that financing problems do exist for some borrowers in some markets, and uncertainty over what the future holds abounds.

Rural Financial Markets

Financial markets are composed of institutional and noninstitutional suppliers of credit and other financial services and the households, businesses, and governments that demand these services.[1] Business firms, entrepreneurs, and local governments all need funds to pay salaries, purchase inputs, carry inventories, and the like. When earnings do not closely match the timing of these expenses, borrowed operating capital can help bridge the gap. Purchases of major pieces of equipment, new plants and buildings, and infrastructure that are expected to serve as inputs into the production process for many years typically require large funding commitments for long periods. The availability of debt or equity capital allows businesses and governments to meet their physical capital needs in a timely and efficient manner.

Access to financial markets, allowing firms and governments to borrow short- and long-term debt capital and allowing firms to raise equity capital (or to invest excess revenues), heightens the ability of these entities to quickly respond to changes in product demand, technological developments, and other unexpected problems or opportunities. The institutional providers of financial services are many and varied, including public and private institutions, regulated and unregulated firms, those primarily providing short-term debt capital, and those providing equity capital (chapter 2). Relatives, friends, patrons, former owners, merchants, and dealers also provide financial services to rural borrowers. But, the financial market most rural businesses face is composed of relatively few local institutions and individual investors (chapter 3). The same is probably true for most small rural governments (chapter 4).

Most rural businesses and governments are small. As such, they do not command the attention of regional or national financial markets.[2] Instead, rural businesses and governments typically rely upon the institutions and investors within their community to provide the financial services they need to operate effectively. For many rural banks--the primary source of debt capital to small rural businesses and governments--the geographic size of their service area is very limited. The business loan market for many banks is approximated by a 10-15-mile radius around the bank's headquarters, with bank officials expressing considerable reluctance to make loans to businesses located beyond this limit (*18*).[3] And, these same banks probably have a

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[1] While households and the individuals in them are the ultimate benefactors of development policy, our concern in this report is how well capital markets serve the financial needs of rural businesses and governments.

[2] Regional and national financial markets typically handle debt and equity financing for larger firms and governments that have large capital needs and established credit histories.

[3] Italicized numbers in parentheses identify literature cited in the References at the end of this chapter.

narrowly defined market for tax-exempt financing as well.[4] Thus, rural businesses and governments probably lack a wide range of financial institutions from which to choose (*12*).

Corporate and informal providers of business equity capital are also probably scarce. Rural businesses generally lack the size and growth potential needed to acquire affordable capital from either a public stock offering or the venture capital industry. In addition, venture capitalists closely monitor the businesses in which they invest, favoring those near their offices (*6*). Because venture capital firms typically locate in urban settings, few invest in rural businesses (*14*). Thus, rural firms get most of their equity capital either from the proprietor or from informal investors. Informal investors do not necessarily want to be part of daily operations, but they are likely to invest in firms and governments operated by people they know (*22*). Thus, rural businesses and governments face highly fragmented and localized financial markets for most of their debt and equity capital needs. Financial market integration has allowed rural businesses to gain indirect access to national debt markets through their local banks, but no such arrangement has developed within the equity capital markets.[5]

The Rationale for Federal Involvement in Financial Markets

The Federal Government, through the efforts of numerous regulatory agencies, has a significant influence over how financial markets operate. Charged with protecting the safety and soundness of the financial system, these agencies often limit the scope of services that each type of financial institution can provide. In the process, Federal regulations determine, to a large degree, the cost and availability of financing for rural (and urban) businesses and governments. Although changes in Federal regulations or the way agencies apply existing regulations affect rural financial markets, they remain outside the purview of this report. In doing so, we implicitly assume that the regulatory environment is determined by the country's need

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[4] Small rural banks have historically been strong supporters of the tax-exempt bond market in general and of their local government's bond issues in particular. The benefits of supporting their community's local economy create a demand for locally issued government bonds and, until recently, the benefits of tax-exempt bonds also created a demand for the highly rated and marketable bonds of larger governments (*17*). But rural banks probably do not invest heavily in the unrated and illiquid securities issued by small rural governments outside their service area (*20*).

[5] The integration of rural and national financial markets allows rural banks to tap national markets for loanable funds, but many rural banks seem reluctant to take advantage of this possibility. Product market deregulation, allowing commercial banks to play a larger role in equity financing, could better integrate rural equity markets with regional and national markets, but the available evidence suggests that recent Federal legislation concerning this issue would only slightly affect rural businesses (*9*).

for a stable financial system, and that rural economic development programs have to work within the framework dictated by Federal financial market regulation.

Most rural borrowers face local and regional capital markets that allocate a limited supply of funds among alternative uses. In the process, some investments judged too risky are excluded from receiving financing. Thus, the operation of highly localized capital markets help determine the pace at which productive capital is accumulated within rural economies and its distribution. Concerns over the way these local markets allocate capital are often at the heart of calls for increased Federal involvement in rural financial markets. Federal programs that assist rural businesses and governments attempt to improve the efficiency of private sector markets or distribute employment opportunities, income, and public services more equitably than would occur in the absence of Federal involvement.[6]

Federal intervention in financial markets on efficiency grounds can be further categorized into concerns over capital market failures and concerns over other market failures that can be addressed through governmental manipulation of capital markets. The economic arguments and evidence for government intervention in rural capital markets on efficiency and equity grounds are not new, but they bear repeating (*1*, *11*, *23*).

Correcting Financial Market Failures

Efficient capital markets transfer available funds from savers and investors to those businesses and governments that can make the most productive use of additional funds. Financial institutions are involved as intermediaries, reducing the transactions costs associated with this transfer. To the extent that public or private financial institutions misdirect the flow of funds away from highly productive uses of capital in favor of less productive uses, economic efficiency can be improved by government intervention that corrects this behavior.

The fear is often voiced that rural banks lack the experience to accurately evaluate loan applications from "unfamiliar" firms. Another concern is that rural banks are not effective brokers of the loans they are asked to originate; that is, they do not make extensive use of loan sales as a method of serving the financial needs of their clientele. Chapter 3 cites evidence for both

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[6] Efficiency and equity are the key concepts of positive and normative economics. Moving from an inefficient to an efficient distribution of resources increases productivity. Equity is concerned with how "fair" society views the distribution of resources. But, equity has a different meaning in discussions of finance. Used in conjunction with terms such as capital or participation, equity refers to the ownership of assets. The intended meaning of equity within this report should be clear from the context of its use.

concerns. Not only are "unfamiliar" firms more likely to report problems acquiring adequate credit, but larger firms and firms in the area's dominant industry also report a high incidence of problems. The latter situation probably reflects the understandable desire of local bankers to diversify their loan portfolios and the general reluctance of rural banks to use complex funding mechanisms--such as loan sales or guarantees--that might allow them to better serve the credit needs of large firms needing loans that exceed the bank's lending limit or the credit needs of the dominant industry.

Another problem for small businesses everywhere is the dearth of long-term debt and equity capital. Commercial banks, relying as they do on short-term deposits for loanable funds, are reluctant to make long-term loans. And they are generally precluded from making equity investments by bank regulations. Thus, complex financial arrangements are often needed to service the long-term capital needs of growing businesses, arrangements that either shift a lot of the risk back onto the borrower (which does not work well for borrowers lacking collateral) or distribute it to investors. But, rural banks are far less likely to participate in such arrangements or even to refer potential borrowers to the people or institutions that could help. Rural communities are less likely to be served by the publicly supported institutions whose business is aiding long-term and startup lending through subordinated loans, loan guarantees, and equity investments (small business investment corporations, community development corporations, business and industrial development corporations, and various other quasi-public revolving loan funds). Thus, rural communities lack the institutions needed to create an efficient equity capital market. According to one study, "the [informal equity] market is clearly the most inefficient equity capital market in the United States, if not the world" (*22*).

In the tax-exempt bond market, the primary concern is over rural governments' limited access to regional markets. Rural governments, with their limited resource bases, undiversified economies, and part-time staffs, do not tend to receive favorable credit ratings (chapter 4). Furthermore, their modest credit needs often fall well below the amounts needed to minimize the cost per dollar of a bond issuance and cannot come close to the volume needed to support a healthy resale market (*21*). Thus, small governments may have difficulty affording the rates needed to attract a broad group of nonlocal investors, even for infrastructure projects that are certain to generate healthy rates of return.[7]

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[7] Analysis of rural tax-exempt bond sales during 1977 and 1982 failed to find any evidence that rural issuers were required to pay high interest rates, given the character of their bond issues (*13*, *20*). The lack of observed interest rate differentials, however, does not prove that no problems exist. If rural governments do not have access to regional bond markets and if local markets are unwilling or incapable of meeting public finance needs, then the "problem" would be the absence of needed bond sales, not their cost.

In a competitive financial system with perfect knowledge and without transaction costs, these problems could not long exist. But in the real world, information is scarce, transaction costs may be high and may vary systematically across geographic space, and localized markets coupled with barriers to entry may severely reduce competition within rural financial markets. These characteristics can lead to the inefficient operation of financial markets, with the result being slower economic growth in some rural communities. Federal intervention aimed at reducing the costs of financial market inefficiencies should ideally address the root causes of the problem, and then only if a cost-effective solution can be found. That is, a program should be adopted only if its benefits to society exceed its costs.

Correcting Other Market Failures

Failures within product markets may justify government intervention even in economically efficient financial markets. Markets fail to achieve economically efficient outcomes whenever marginal social cost does not equal marginal social benefit. For example, pollution imposes costs to society that are not reflected in the market prices of goods produced. Thus, private market decisions result in overproduction and consumption of "polluting" goods. Governments may try to alter private market outcomes in many ways, but one tool often relied upon is subsidized credit. In the pollution example, government regulations and subsidized credit have been used to encourage the adoption of cleaner production techniques.

With regard to rural development, many observers argue that private markets do not consider the costs to society when deciding where to locate, relocate, or abandon production facilities (*2*). Thus, businesses locating to increase their own profit potential impose higher than necessary costs on society (for over- and underused infrastructure and deterioration of community amenities, for example). The movement of human resources can generate a spiraling effect, wherein rural communities losing population might not be able to reestablish long-term economic stability. Net outmigration in rural labor markets reduces returns to capital, further dampening new investment.

The broader public good served by many local government activities, such as education, sewage treatment, health care, and transportation networks, creates a situation where the supply of rural public services would probably be suboptimal without some form of intervention by higher levels of government. Thus, local governments find themselves responsible for providing a growing number of activities and services mandated by the Federal and State governments. In some cases, intergovernmental assistance partially defrays the cost of these mandates, but this practice is far from universal.

The public good argument can also be applied to the benefits the Nation derives from the continued existence of small towns, scenic rural settings, family-sized farms, "mom and pop" businesses, and other such institutions (*2*). If America's vision of itself requires their continued existence, society may be ill served by private market decisions.[8] Attaching a dollar figure to these benefits (benefits that rural residents and businesses will not be reimbursed for through a free market mechanism) is extremely difficult. However, the political support enjoyed by farm programs, Small Business Administration (SBA) activities, and rural development programs is grounded in the notion that program beneficiaries deserve some level of governmental support as compensation for the treatment they receive at the hands of the market.

The use of credit programs is not the only, or generally the most efficient, way of correcting for noncredit market failures.[9] However, reducing the cost of public and private capital accumulation in disadvantaged rural communities by reducing the interest or transactions costs on borrowed funds is one approach policymakers have adopted in the past. Because the problems being addressed are not peculiar to the financial services delivery system, "solutions" use financial markets to influence investment decisions rather than to correct financial markets.

Meeting "Fairness" Criteria

Certain regions of the country (including many rural areas) have experienced slower growth rates and lower standards of living than has the Nation as a whole. Equity may argue that the Nation's wealth should be shared more equally among all regions of the country. In the public sector, economies of scale place small governments serving widely dispersed populations at a distinct cost disadvantage. The cost per unit of providing public services in rural settings is often high, while the revenue base of many rural jurisdictions is very limited (chapter 4). As a result, far fewer public services are provided to rural residents, and tax burdens in remote rural areas are often as high as or higher than those borne by the residents of central cities. Low population density, greater distance to markets, and difficulties attaining economies of scale make it costly for the private sector to provide many goods and services in remote rural settings. Rural firms have access to far fewer business services than do urban firms, making growth and development more difficult (*6*). And rural residents have lower incomes,

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[8] The benefits may not be entirely psychic. Many argue that economic stability, heightened competition, and more rapid technological innovation are societal benefits attributable to the operation of many independent producers.

[9] Credit subsidies, either through lower interest rates or easier loan terms, favor capital-intensive production techniques over other, sometimes less costly techniques.

making it more difficult for them to afford those services that the Nation considers essential for modern living (*8*, *15*).

If these conditions move society to redistribute resources to meet equity criteria, the assistance need not be funneled through credit programs. Indeed, much "equity-based" assistance is in the form of income support and transfer payment programs.[10] However, if higher costs of real capital are believed to be one source of spatial inequity, programs which reduce the cost of financial capital within rural areas may serve our desire for a fairer distribution of economic activity and its rewards. Programs which deliver a real cost saving can be effective (although not necessarily efficient) at meeting equity objectives.

Federal "Rural Credit" Programs[11]

Federal credit programs are not administered solely for one purpose, whether it be increasing economic efficiency or improving equity. The nature of our political process, with its emphasis on coalition building, tends to result in programs that are not clearly focused on one particular goal, but rather serve many economic, political, and social goals. Programs themselves evolve with the changing sentiments of the American public and as financial markets change.

Basic Approaches for Intervening in Financial Markets

Government intervention in financial markets can take many forms. Chapter 5 provides a good overview of Federal "credit programs," with an eye toward the effect each approach has on the Federal budget. Although the approaches remain the same, our concern here is with how they affect financial market operations and help economic efficiency or equity.

Federal grants and direct loans and equity investments for infrastructure and productive capital essentially replace the private sector financial market with Federal funds. Grant programs have the Federal Government assuming responsibility for financing all or part of approved projects, while direct loan

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[10] Transfer payments made up 62 percent of the Federal funds received in nonmetro counties during 1985 (*4*).

[11] This section includes both debt and equity capital programs within the phrase "rural credit." Credit programs are not the only, or even the most important, way the Federal Government influences financial decisions. The Government's primary role within the financial services delivery system is to insure its safety and soundness. Through deposit insurance, the regulation of insured institutions, and its overall fiscal and monetary policies, the Federal Government significantly influences the distribution of loanable and investable funds. Our concern here is with Government intervention in financial markets for the explicit purpose of aiding economic development.

programs have the Government serving as banker for approved projects, providing funds (often at below-market rates) that are then repaid. While rare in practice, direct equity investments have the Government becoming part owner of the business being financed.

These programs are potentially useful for attaining objectives unrelated to credit market failure. For example, Federal grants for infrastructure have long been used to entice State and local governments to provide a mix of public services that meet the needs of the Nation and the parochial needs of local residents. Direct loan programs offering below-market rates or easier loan requirements provide subsidies to targeted borrowers. And direct investments have rescued firms whose impending failure would have disrupted the National economy. Because these programs give the government control over loan and investment evaluations and terms, the subsidies can--at least in theory--be tailored to best meet developmental objectives. But grants and direct loans or investments to "end-users" of these funds may not be efficient when problems are grounded in the financial markets themselves.

To the extent that market fragmentation, a lack of competition, and high transactions costs portray the rural financial landscape, programs that improve market integration, heighten lender competition, and lower transactions costs may foster rural development. Market integration can be heightened and transactions costs lowered through secondary markets for business loans and local government securities. Secondary markets allow lenders to make loans that are then sold to loan poolers who use the loans as collateral for securities sold to the investing public. By standardizing loan terms and pooling similar debt instruments, these markets reduce the time and expense needed by investors to evaluate investment risk. Furthermore, by lowering the cost of making loans and by spreading risks, secondary markets generate more competition among potential lenders.

Loan guarantees, wherein a government agency covers some fixed percentage of the losses associated with a borrower's default, can also be an effective tool for reducing lender reluctance to make "unfamiliar" loans and can reduce inefficiencies associated with credit rationing (*19*). To the extent that a guarantee program encourages lenders to broaden the geographic size of their markets, these programs also heighten competition within rural financial markets.

The absence of institutions willing and able to provide equity investments in small startup firms has been a major shortcoming of many rural (and urban) financial markets. Federal funds have been used as capital for quasi-public revolving loan and investment funds, thereby encouraging the development of a new class of financial intermediaries. The development of small business investment corporations and other revolving loan funds in rural communities can improve the efficient operation of the financial markets serving these communities. These funds entice the involvement of lending institutions in risky projects by providing subordinated debt and equity capital and technical assistance to the borrower. But, they can also serve as small-scale venture capital firms, pooling the funds of small, local investors to make equity investments in small local firms.

Still another approach governments at all levels can take to improve the efficiency of financial markets is to provide technical assistance and specialized education to small businesses, governments, and financial services providers. By improving the ability of lenders to weigh the potential risks and rewards associated with a financing request, and providing borrowers with a better understanding of their financing options, technical assistance can substantially improve decisionmaking. The SBA has, for many years, provided management training and assistance to small businesses and entrepreneurs, helping them develop the sound business plans and loan requests needed to successfully finance their operations. Many State Governments provide similar assistance to the elected representatives of local jurisdictions and their professional staffs. By improving the quality of information available to both borrowers and lenders, these efforts help overcome one of the major causes of inefficient capital markets.

Loan guarantees, secondary markets, the partial capitalization of revolving loan funds, and technical assistance all work through financial markets. From a budget perspective, they are cost effective in that they leverage scarce rural development funds by enticing increased participation by private capital providers. They also draw upon the strengths of private financial institutions rather than attempting to replicate these characteristics within Federally administered programs. But they are less likely to be useful as solutions to society's concerns over the distribution of economic resources or to nonfinancial market failures. These concerns require either an explicit subsidy to the borrower or the assumption of abnormally high risk by the lender, neither of which is likely in an efficiently operating financial market.

The Government also influences the cost of financial capital for infrastructure and business investments through the tax code without directly affecting the operations of financial markets themselves. By allowing business interest expenses to be deducted from taxable income, the tax code effectively lowers the aftertax cost of debt-financed capital purchases. Tax credits and capital gains preferences have also been used to raise the aftertax returns on business investments.

The tax-exempt status of State and local government securities is the most widely used mechanism for subsidizing infrastructure.[12] By exempting the interest income earned on these securities, the U.S. Treasury effectively raises the aftertax return on tax-exempt versus taxable securities. Thus, interest rates on tax-exempt bonds are lower than those paid by other borrowers. The tax code has been used to stimulate investment nationwide. But, by selectively granting the right to issue tax-exempt bonds, the Federal Government is now trying to limit the resulting subsidies. More explicit targeting of tax expenditures might stimulate additional investment in those places, or for those purposes, that would underinvest (from society's point of view) if faced with market rates of interest.

Recent Trends in Federal Intervention

With regard to rural credit programs, legislation during and immediately after the Great Depression was aimed primarily at addressing perceived problems with rural capital markets (chapter 5). However, inflexible loan terms subsequently increased the size of the credit subsidies embodied in several programs. And the creation of new programs responsive to rural needs, such as General Revenue Sharing, suggests that "fairness" considerations gained in importance up to and through the 1970's.

The "New Federalism" of the 1980's emphasized smaller, less direct Federal economic development programs. Federal involvement in economic development was reduced, both on philosophical grounds and in response to the rapid growth in the Federal budget deficit during the 1980's. Those programs that survived were often transformed to reduce their effect on current budgets. Federal spending for economic development dropped from $11.3 billion in 1980 to $5.3 billion, in nominal terms, by 1988 (chapter 5). Loan guarantees, insurance, and increased reliance on Government-sponsored enterprises replaced Federal grant and direct loan programs. The Tax Reform Act of 1986 significantly altered the tax advantages previously reaped from business investments and tightened eligibility rules for the use of tax-exempt bonds (*5*, *17*).

Current proposals regarding Federal financial assistance to rural businesses and governments continue the trend toward lower Federal allocations and heavier reliance on State and local governments and the private sector. Budgetary pressures are as severe as ever, so legislation that does not involve

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[12] State and local government officials argue that the tax-exempt status of their securities is a constitutional right rather than a Federal subsidy. The benefits enjoyed by borrowers are, however, directly related to the losses incurred by the Federal Treasury. Recent court decisions have also raised serious doubts about the degree of Constitutional protection from taxation afforded municipal bond holders.

higher budgets tends to be preferred over more costly alternatives. The Senate's rural development bill (S.1036) provides an additional $300 million annually for numerous provisions, including several to help establish and expand rural business and improve physical infrastructure. The House bill (H.R.3581) includes no new funding, but rather redistributes funds from current programs (*7*). Both bills limit the Federal role to one of enticing greater private sector capital into rural areas through the use of revolving loan funds, insurance, guarantees, and technical assistance. The same trend holds for State rural development financing programs (*3*).

Financial Market Intervention and Rural Development

Programs that minimize today's governmental spending may be politically popular, but they are not necessarily the cheapest in the long run, and they may not effectively serve our rural development objectives. Accurately estimating the ultimate costs of contingent liabilities is difficult, and the Nation lacks a clear, coherent rural development policy. Thus, the information and standards needed to evaluate alternative rural credit programs are nonexistent. Our assessment of the rural financial services delivery system, however, serves as a basis for evaluating the utility of altering governments' current role in financial markets to further specific rural development objectives.

While economic efficiency and equity considerations serve as the underlying economic rationales for Federal rural development strategies, they are not the typical objectives voiced by policymakers or the public. Rural development means different things to different people, but this report concentrates on two possible objectives: (1) preserving the viability of rural communities as places to live and work and (2) overcoming some of the income and standard of living disadvantages experienced by rural residents. What role can financial market intervention play in meeting these two objectives?

Whether on efficiency or equity grounds, government intervention in financial markets aims to reduce the cost or increase the availability of financial capital in rural areas. The intervention may target specific areas (perhaps through enterprise zones) or specific investments (for example, farm loan guarantees). If eligible investments become economically attractive because of Federal intervention, investment in rural public and private capital will be stimulated.[13] Properly allocated improvements in rural physical infrastructure directly improve the rural standard of living

[13] This assumes that intervention does not merely transfer scarce financial resources from one rural project to another.

(through the provision of clean water, safe and convenient transportation networks, and other capital-intensive local government services) and increase the economic return on private investments. A higher stock of physical capital in the private sector increases labor productivity and, in a perfectly competitive economy, should increase the economic returns to labor. Thus, Federal intervention in financial markets, by stimulating investment in rural physical capital, can increase the quality and availability of public services provided by rural governments and the average wage rate earned by rural workers.

Appropriately targeted investments might be stimulated in relatively labor-intensive industries, thereby increasing job opportunities in rural communities. But, isolated financial market incentives will have an effect only if investment opportunities become economically attractive as financial capital becomes more available or less costly. If no such opportunities exist, or if other obstacles prevent their coming to fruition, then long-term governmental intervention in financial markets will be ineffective.[14]

As the cost of capital within a firm's production process becomes less important (as its use of better paid employees increases, for example), the relative size of the capital subsidy needed to make the firm economically attractive increases. Thus, credit programs initiated to create more jobs in rural areas may require costly subsidies.

For most rural communities, financial market intervention can, at best, serve as only one approach within a broader package of rural development strategies. If the lack of skilled labor, distance to markets, or the inability of entrepreneurs to develop attractive business proposals are also slowing rural development, then financial market programs alone will not be successful, or will be prohibitively expensive.

Governmental intervention in rural financial markets will probably have the greatest developmental impact for the money in those areas whose financial markets are inefficient. Where financial markets are already efficient, government intervention will probably require higher Federal subsidies (either in the form of current budget allocations or in contingent claims on future Federal budgets) to obtain developmental objectives.

Deregulation, financial innovations, and technological advances have succeeded in more closely integrating rural credit markets with national and international markets over the last decade. Thus, the available evidence suggests that rural debt markets are usually reasonably efficient (*3, 18*). The

[14] Even ineffective programs can be costly, both to the U.S. Treasury and to the economy.

degree of integration varies considerably from community to community, however. The probability that a particular local financial market operates efficiently declines as the number of financial providers declines. Markets exhibiting monopolistic tendencies are not known for their low costs or innovative behavior. Policies aimed at increasing the number of financial providers serving rural communities, therefore, could prove beneficial.

Geographic deregulation during the 1980's increased the number of commercial banking firms operating in some rural counties, but many rural markets are too small to support a large number of full-service banking offices (*12*). Policies that broaden the geographic size of the markets served by existing lenders and investors may be needed instead. Loan guarantees, secondary market programs, and revolving loan funds all allow lenders and other capital providers to serve broader markets.

The efficiency of rural debt markets may benefit from marginal changes in Federal involvement, but much larger efficiency gains are possible within rural equity markets. At the heart of the problem with rural equity markets is the lack of an institution or mechanism for systematically bringing entrepreneurs and investors together. Further deregulation of depository institutions, allowing them to make equity investments, might alleviate this problem. Recent experience in the savings and loan industry, however, shows such a step involves considerable risk. Modest capital investments in locally organized revolving loan funds may best meet the equity capital needs of rural businesses.

The significant societal benefits associated with many local government activities suggest that Federal grants and direct loan programs have a continuing role in infrastructure finance. The relative ease with which subsidies can be delivered through these programs recommends their use in addition to the market improvements discussed above.

The existence of a Federal program does not ensure its use. Many programs already on the books are not widely used by rural lenders or borrowers (chapter 3). Heightened competition among rural capital providers would probably increase the use of existing Federal credit programs, shorter term results could come from technical assistance programs that help borrowers and lenders develop attractive financing packages, with or without the use of Federal programs. Rural financial markets generally do not suffer from a shortage of funds. Problems more likely reflect the unwillingness of lenders to use complex, innovative financing techniques to serve the financial needs of rural businesses and governments, and the inability of borrowers to develop realistic business or development proposals and to persist in looking for capital suppliers in the face of loan rejections.

Uncertainties Over the Future

Our current assessment of the rural financial delivery system--that overall performance is adequate but that marginal changes could prove beneficial--is determined, in part, by the Federal Government's current role in that system. The rural financial system depends upon Federally insured depository institutions, particularly commercial banks. The structure and behavior of these institutions is directly affected by the Federal regulations and deposit insurance system used to insure the safety and soundness of the financial system.

Largely as a result of the savings and loan debacle, but also because of concern over recent losses to the commercial bank deposit insurance fund and loan portfolio problems in several Government-sponsored financial institutions, the current form of Federal deposit insurance is coming under attack. Some of the proposed alternatives to the present system, which insures deposits of up to $100,000 per account, could increase the risk of depositing funds in smaller financial institutions. Other proposals would severely limit the ability of depository institutions to use insured deposits to make risky loans. That even minor changes in government regulations can have a pronounced effect on lender behavior is evidenced by the adjustments the savings and loan industry is undergoing in response to the Financial Institutions Reform, Recovery, and Enforcement Act (*16*). Changes in Federal deposit insurance coverage or Federal bank regulations that severely constrain small banks' ability to make business loans will hurt rural areas the most.

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Chapter 2

The Changing Nature of the Rural Financial System

Daniel Milkove*

Rural banks and other lending institutions can aid rural development by accepting creditworthy loan applications, giving technical assistance and advice to owners of young firms, and helping entrepreneurs identify governmental assistance programs in cases where loan applications are judged excessively risky. But, banks cannot create economic growth on their own, and they should not be in the business of making loans with only marginal repayment chances.

Overview of Rural Financial Institutions

The private sector in rural communities, consisting of firms and households, is served by a wide variety of financial organizations. Lending institutions can be differentiated in many ways: public or private; for profit or nonprofit; large or small; locally oriented or geographically diversified; specializing in certain financial products or providing a comprehensive range of services. They also differ by source of loanable funds, by length of loan maturity, and by whether they make debt or equity investments.

This chapter emphasizes the private financial institutions, particularly commercial banks, that are responsible for most rural business credit. But other types of lenders are important players for specific services, and access by some of these lenders to national money markets may free up local funds for rural development finance. Other lenders are briefly described here to better portray the potential range of rural lenders, but they are treated more fully in chapters 4 and 5.

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Private Lenders

The U.S. financial delivery system consists largely of privately owned firms, providing services for the express purpose of earning profits. Nonprofit corporations and organizations also play key roles in the packaging of financial instruments. But if rural development is being hindered in some way by inadequate access to capital, the solution will have to involve private lenders.

Commercial Banks

Commercial banks are the dominant private providers of credit in most rural financial markets and for most financial services. In early 1989, 55 percent of the 13,051 U.S. commercial banks insured by the Federal Deposit Insurance Corporation (FDIC) were headquartered in nonmetro counties. But the large number of rural banks does not necessarily imply a plentiful supply of rural capital since rural banks tend to be smaller than urban banks.

Numbers of banks vary considerably by State, but not simply due to population or economic differences. Texas had the most banks (1,484), but the more populous States of New York and California had many fewer banks (200 and 475). This observation is explained largely by differences in State branching laws. The latter two States permit their banks to operate branches anywhere in the State. As a unit banking State before 1987, however, Texas precluded its banks from establishing any full service branches. Hence, numerous small banks were formed in Texas to serve various local markets.

Two devices, multibank holding companies (MBHC's) and chain bank systems, have been employed to circumvent constraints on serving multiple markets or operating more than one office in a particular market. An MBHC is a bank holding company that owns more than one bank subsidiary, and a chain is a group of banks with common ownership, but where a holding company is not formed as an outer shell. If the number of separate banking organizations, rather than the count of legally distinct banks, is important when examining competition or concentration in banking, both types of common ownership potentially reduce competition. Little evidence exists on chains, but nearly a third of U.S. banks are affiliates of 945 MBHC's.[1]

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[1] Recent changes in State banking legislation have slowed the growth of MBHC's. Many MBHC affiliates have recently been converted to branches (and thus no longer are included in bank counts) in States, such as Texas, that liberalized branching legislation or States, such as Florida, that permit statewide branching only by merger, rather than through new branches.

Because they tend to have fewer and larger banks, States that permit widespread branching have higher statewide measures of concentration of bank assets. Greater concentration of banking resources would usually suggest less competition. But branching laws may not affect the competitiveness of the local financial markets faced by the typical rural borrower. Small towns are served by few banks regardless of the legislation governing branching and MBHC acquisitions. The difference is that some of the small town bank offices may be branches of urban banks (in branching States) or affiliates of MBHC's (in States that restrict branching), rather than independent banks. In the context of competition, what should matter is the number of different banking organizations serving the community.

Liberal branching regulations increase per capita bank offices in metro counties, but differences among rural counties with differing branching laws are insignificant. In 1983, the population per urban bank office (including main offices and branches, but excluding drive-in facilities and other offices that showed no deposits) averaged 9,723 in unit banking States, 5,409 in States with liberal branching (some branches permitted, but with numerical or geographic limitations), and 4,900 in States with statewide branching (*5*).[2] The corresponding rural figures were 3,231, 3,227, and 3,390. In 1986, the typical rural county averaged 8.1 banking offices belonging to 4.1 banking organizations (*6*).[3] Urban counties averaged 52.3 offices and 11.0 organizations. Averages can hide a considerable amount of diversity. About 30 percent of rural counties were served by only one or two banking organizations, while 24 percent had offices of at least six different banking organizations.

Some rural advocates feel that outside ownership of rural bank offices might prove detrimental to local development prospects. Large banks may transfer funds from rural offices for lending elsewhere, and nonlocal managers may lack information needed to fairly evaluate loan applications. Other arguments favor outside ownership, because large banks provide more kinds of financial services, can handle larger loan requests, and are affected less by downturns in the local economy. A third of rural counties are served solely by local banking organizations (banks with no offices outside that county), and slightly more than half contain offices from both local and nonlocal banking organizations.

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[2] Italicized numbers in parentheses identify literature cited in the References at the end of this chapter.

[3] An MBHC with two bank affiliates in the same county is treated as a single banking organization.

Savings and Loan Associations

Savings and loan associations (S&L's or "thrifts") have long enjoyed greater latitude to establish branches in many States that severely restricted branching activity by banks. Thus, the number of S&L branches, both in all counties and in rural counties, is large in relation to the number of S&L firms. By June 1988, only 3,079 S&L's remained in business, but they operated 22,560 offices. Of the total, about 20 percent were in rural counties. Most rural S&L offices were small, with only 96 having deposits above $100 million.

Legislation during the 1980's gave S&L's many powers that were previously reserved for commercial banks. Thrifts can now provide NOW accounts (interest-bearing checking accounts) and make commercial loans, thus moving away from their traditional base of originating home mortgage loans with funds kept in savings accounts. Some States even permitted S&L's to undertake activities not available to banks, such as insurance sales and direct commercial real estate investments.

Despite their branching ability and increased range of permissible financial services, S&L's are unlikely to be major lenders for rural businesses, even in rural areas where lagging development prospects are blamed on bank inaction. By late 1989, a third of the thrift industry was insolvent and in no shape for rapid expansion. In fact, growing too fast and entering new lines of business significantly contributed to the quagmire that hampered the S&L industry in the late 1980's.

The Financial Institutions Reform, Recovery, and Enforcement Act of 1989 provides funds to handle insolvent thrifts, and restructures the regulatory framework to prevent future problems. One provision allows banks to purchase healthy S&L's. Such purchases may attract more private capital, thus reducing the public cost of the S&L bailout, but they will also quicken the process by which the two industries merge. Some experts promote that idea, arguing that a separate S&L industry is no longer required to facilitate mortgage lending. With expanding securitization of mortgages, S&L's are not needed to hold mortgages. Most investors and financial institutions can purchase mortgage-backed securities, and banks or mortgage bankers can originate mortgages.[4]

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[4] Banking regulators incorporate thrift deposit data when examining the local competitive effects of proposed banking mergers. Horizontal mergers (combining firms in the same market) increase market concentration, but including thrift deposits lessens the likelihood that the measured increase in concentration will exceed guidelines established by the U.S. Department of Justice. Hence, the potential benefits from thrifts competing with banks may be partially counteracted by bank mergers that otherwise would have violated antitrust regulations if S&L's had remained distinct institutions.

Other experts, however, believe that a thrift industry that returns to originating and servicing home mortgages can remain healthy and useful. They argue that S&L's should emphasize the origination of residential mortgages and sell fixed rate mortgages to the secondary market to avoid the interest rate trap inherent when short-term deposits are used to fund long-term loans. Thus, S&L's would earn fee income from the mortgage originations and investment income from their variable-rate loans. Regardless of their future role, S&L's cannot be relied upon to lead rural development efforts.

Other Lending Institutions

In many respects, mutual savings banks and credit unions are also now very similar to banks. Mutual savings banks are covered by FDIC insurance and credit unions by their own insurance fund. In 1987, the 371 mutual savings banks and their 2,569 branches were found in only 15 States (*2*). Some mutual savings banks are quite large (aggregate deposits exceeded $201 billion in 1987), and they have a strong presence in the Northeast. But because of their geographic concentration, savings banks do not serve most markets, rural or urban. Outside the Northeast, Washington had 203 offices, but Alaska, Indiana, Oregon, and Wisconsin had at most 7 offices each.

Credit unions are numerous but generally very small, even compared with rural community banks. At the end of 1987, 14,358 Federally insured credit unions held close to $165 billion in assets (*2*). The latter figure is large in absolute terms, and its growth rate has been rapid in recent years. But, total credit union assets pale in comparison with the $3,001 billion held by the banking industry and average below $12 million per credit union.

Credit unions are known primarily for catering to the personal loan needs of their members, such as providing automobile and vacation loans. Because of volunteer labor and free space from the firm or organization with which they must be associated, credit unions have slowly gained market share by passing on their lower costs in the form of higher yields on deposits and lower interest rates on loans. However, some bankers now see credit unions as potential competitors on a wider scale. Credit unions are beginning to offer new services, such as interest-bearing checking accounts and first mortgages, and they are pushing the limits of the common bond membership requirement that limits the potential size of most credit unions. Bank opposition was intensified following the creation of a national credit union for senior citizens by the American Association of Retired People.

Farm Credit System

Unlike the other types of financial institutions, affiliates of the Farm Credit System (FCS) are heavily concentrated in rural areas. The FCS makes loans to farmers and farm cooperatives through a system of 25 banks and 267 associations.[5] Although the number of associations is small compared with commercial banks, the FCS serves a national market.

FCS institutions do not accept deposits from the public; consumers do not maintain checking or savings accounts with these firms. Instead, the FCS raises funds by selling bonds on a centralized basis in the national money markets. The proceeds pass through district Farm Credit Banks to individual associations for lending to local farmers. Obtaining loan funds from outside the local region frees banks and other depository institutions to use locally raised funds (that might otherwise have gone into farm loans) for other purposes, such as small business financing. Furthermore, FCS bonds are sold at very favorable interest rates because investors believe that the Federal Government stands behind the bonds, thus reducing the risk of loss should the FCS default.

Financial difficulties in the FCS peaked during 1985-87. The severe recession in the agricultural sector affected both the FCS and thousands of commercial banks that depended heavily on agricultural loans. Several hundred agricultural banks (those with above-average concentrations of agricultural loans) ultimately failed. But as an industry, the FCS ended up in even worse shape due to its lack of diversification, large holdings of farm mortgages, average cost pricing of loans, and a large stock of fixed-rate, noncallable bonds sold at high interest rates (*4*). Financial health has been restored, at least for the time being, by the Agricultural Credit Act of 1987. Still, some supporters would like to see the long-term health of the FCS strengthened further by giving it authority to expand its activities beyond farm lending. Commercial banks have fought all such attempts, however, because they believe its Federal agency status gives FCS institutions an unfair advantage in providing financial services that banks themselves provide.

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[5] This count includes the traditional Production Credit Associations and Federal Land Bank Associations, and the newer Agriculture Credit Associations and Federal Land Credit Associations. FCS also consists of the National Bank for Cooperatives, and a central Farm Credit Bank (FCB) in 11 of the 12 FCS Districts. Because its Federal Land Bank (FLB) is in receivership, the Jackson (Mississippi) District was unable to merge its FLB and Federal Intermediate Credit Bank to form an FCB. The Springfield (Massachusetts) and St. Paul Districts each maintain separate Banks for Cooperatives.

Other Government-Sponsored Private Corporations

The Federal National Mortgage Association ("Fannie Mae") and the Federal Home Loan Mortgage Corporation ("Freddie Mac") support secondary markets in residential mortgages. They are now publicly owned corporations but, like FCS, they were initially chartered by the Federal Government. By purchasing mortgages from originating lending institutions, selling securities backed by these mortgages, and helping to standardize lender creditworthiness criteria, Fannie Mae and Freddie Mac make mortgage funds more widely available and at lower interest rates.

Banks and thrifts can earn fee income by originating loans and perhaps by servicing them as well, but interest rate risk (losses that occur if deposit rates rise above the interest rate received on fixed-rate mortgages) and credit risk (losses due to loan delinquencies) are eliminated by selling the loans. Loan sales also release funds for additional lending. Investors in mortgage-backed securities benefit by acquiring a small piece of many different mortgages, each meeting specific underwriting standards. Some portion of these benefits is also passed back to borrowers in the form of lower interest rates. The secondary markets also increase the availability of credit for the housing sector.

The Federal Government also supports secondary markets for other types of loans. The Student Loan Marketing Association ("Sallie Mae") supports a secondary market in federally guaranteed student loans. The Federal Agricultural Mortgage Corporation ("Farmer Mac") is developing a secondary market for farm real estate loans. Secondary markets for other types of loans have also developed without the benefit of Government support. Both automobile loans and credit card receivables have been pooled to back securities. However, no market has yet developed for resales of unguaranteed business loans, prompting proposals for Federal activity in this area.[6] For example, a bill currently before Congress would create the Venture Enhancement and Loan Development Administration for Small Undercapitalized Enterprises ("Velda Sue") to support a secondary market in small business loans.

Pension Funds and Insurance Companies

Pension funds and insurance companies have huge reserves of funds that are invested on behalf of members and policy holders. These institutions are

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[6] A secondary market in SBA-guaranteed loans has existed for some time, with support from the SBA. That market increases the attractiveness of SBA's loan guarantee programs to lenders, but it does not help most small business loans, because SBA does not guarantee them.

large holders of corporate stocks and bonds, and they also invest directly in areas such as real estate. Insurance companies still hold billions of dollars of farm real estate loans but have become less active in that area in recent years. Proposals are periodically made to place pension and insurance money in "socially responsible" investments, such as low income housing or for loans to new businesses. However, the fiduciary responsibilities of these organizations probably preclude large-scale efforts in such areas, unless the investments meet the normal criteria for safety and expected profitability. Pension and insurance companies are beginning to participate more actively as major institutional stockholders of large corporations, to increase the value of their stock.[7]

Finance Companies

Personal finance companies are similar to credit unions in the types of loans they make, but they are not depository institutions. That is, they obtain loanable funds by borrowing rather than through checking and savings accounts. Finance companies are also known for targeting the higher risk segment of the consumer loan market; they charge higher interest rates in return for accepting loan applicants that may not satisfy the creditworthiness criteria applied by banks and other regulated lenders.

The finance company category also includes the "captive" finance subsidiaries of the auto manufacturers and some other large corporations. When interest rates rose to record highs in the early 1980's, automobile companies found that offering low interest rates on car loans was an effective marketing tool. Thus, their finance companies greatly increased market shares for auto loans. Some captive finance companies, notably the General Electric Credit Corporation, have branched into business lending and investment.

Public and Nonprofit Lenders

Various public and nonprofit lending programs have been created over the years in an attempt to fill gaps left by private lenders. Government agencies have assorted programs that make direct or guaranteed loans for specified purposes. Loan guarantees now dominate Federal agency lending activities. By guaranteeing loans, the Government leaves the origination and servicing aspects to private lenders, which are believed to have comparative advantages over Government agencies in these activities. Loan guarantees also remain off-budget unless a loan becomes delinquent. Farm lending by

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[7] This new found activism has come about in the wake of efforts by management at some corporations to fight hostile takeovers that would have meant sizable gains for current stockholders.

the Farmers Home Administration (FmHA), an agency of the U.S. Department of Agriculture (USDA), is probably the most familiar of these programs in rural areas. But FmHA also makes some housing loans and has a program for business loans. The Small Business Administration (SBA) has a national focus, but it is an important source of Government-sponsored debt and equity capital for rural entrepreneurs. These programs are described in more detail in chapter 4 of this publication.

Rural Electrification Administration

USDA's Rural Electrification Administration (REA) makes direct loans to rural electric and telephone cooperatives and guarantees loans made to cooperatives by the Federal Financing Bank, the financing arm of the U.S. Department of the Treasury (*8*). The money for these loans comes from outside rural areas, but small banks could not have handled the large loans required by utilities.

Widespread availability of electricity is critical for rural economic development of all kinds. REA recently granted its borrowers authority to use their funds (up to 15 percent of total utility plant) to promote rural development through direct investments, loans, and loan guarantees. If the electric cooperatives continue to expand their ability to generate electricity (now about 50 percent of their total needs), rather than merely distributing electricity purchased from other utilities, they may find few funds available for development purposes.

Small Business Investment Corporations and Revolving Loan Funds

Besides making and guaranteeing loans themselves, different levels of governments also make grants or low cost loans to nonprofit organizations that, in turn, make loans or equity investments in small or rural businesses. Foundations, community organizations, banks, and other private sources also contribute to the funding of nonprofit corporations that support small businesses. Small Business Investment Corporations (SBIC's) are privately owned but licensed by the Small Business Administration. They make equity investments, which can be critical to the success of new firms. In 1983, SBIC's made 3,247 investments totalling $468.8 million (*7*).

Other local organizations operate federally funded revolving loan funds (RLF's) which use public money to leverage private financing for new or expanding businesses that would otherwise have difficulty obtaining affordable credit. In the late 1970's and early 1980's, the Economic Development Administration funded nearly 350 RLF's. Most of these operate within urban areas, but in the late 1980's, a concerted effort was made to fund rural (generally multicounty) economic development district

RLF's. The SBA also funds RLF's through its Certified Development Company Program. By 1989, over 400 RLF's had received funding from the SBA, but only one-fourth of these are still actively making loans. Other Federal programs, such as FmHA's Intermediate Relending program, the Community Development Block Grant program, and the Community Services Block Grant program have also provided some of the capital needed by RLF's. Thus far, SBIC's and other community-based groups have lacked the resources to make more than a marginal difference in the availability of debt and equity capital to rural businesses.

Private-Purpose Tax-Exempt Financing

State and local governments often use their ability to issue tax-exempt bonds to provide loanable funds to financial institutions or directly to borrowers. Recent examples are mortgage loans for first-time home buyers and packages put together to attract new business firms to the jurisdiction. Because holders of tax-exempt securities do not pay Federal income tax on their interest earnings, State and local governments can sell bonds at rates much lower than those paid by corporations. In the case of mortgages, funds are passed through to banks and other lenders who identify applicants and originate loans carrying below-market interest rates. These programs are popular because they allow State and local governments to assist favored projects without incurring any costs themselves.

Nonetheless, tax-exempt financing imposes hidden costs on the public, and the practice of assisting privately owned firms has raised concerns about efficiency and fairness. Tax-exempt securities mean lost tax revenue at the Federal level, revenue that must be made up by borrowing or raising taxes. Funds borrowed by governments to finance private firms are not available for other, possibly more productive purposes. And firms competing with subsidized businesses have legitimate complaints if they cannot benefit equally from these programs.

The Tax Reform Act of 1986 addressed these issues by limiting the use of tax-exempt bonds for nongovernmental purposes. The legislation also reduced demand for holding tax-exempt bonds by reducing marginal tax rates, imposing a minimum tax covering interest earned on tax-exempt bonds, and eliminating a tax deduction given to commercial banks for interest expenses incurred in purchasing tax-exempt bonds.

Changing Rural Financial Markets over the Past Decade

Numerous forces have affected rural financial markets in recent years. Some factors worked more directly through national markets, others simultaneously affected all parts of the country, and several had a strong rural focus. Rural America's ties with the broad economy have been strengthened by financial deregulation and technological developments. At the same time, the agricultural crisis of the 1980's, primarily a rural phenomenon, profoundly affected many rural financial institutions.

Technological Change

To some extent, the promise of technological advances in financial services surpassed the reality. For example, electronic funds transfer has failed to replace paper checks, several attempts to develop home banking services have failed, and debit cards (which look like credit cards but work like cash by immediately debiting the user's checking account) are not widely used, despite efforts to win consumer acceptance. But widespread computerization is changing how many of us do our banking, has permitted the development of new financial services, and may lead to greater concentration of financial firms due to economies of scale or scope. As banks and other institutions provide new services or merge their firms to take advantage of improved technology, regulators and legislatures struggle to respond in a timely fashion to real or perceived problems.

Automated teller machines (ATM's) let people carry out basic bank transactions at any time of the day and at nontraditional banking locations, such as airports and grocery stores. The number of ATM's (around 80,000) now far exceeds the number of bank offices (about 58,000). Many people resist banking by machine, but others see ATM's as useful additions to the range of choices by which certain activities are performed.

Computers permit brokerage firms to handle volumes of stock trades much larger than levels that would have strangled the system 10 years ago. Advanced communications methods that tie various world financial centers together allow stock trading to be a 24-hour, global operation. Rapid computer calculations have led to program trading, blamed by some for adding a new source of instability to the world's financial system. A minority of rural and urban residents are direct investors in the stock market, but many others participate through pension plans and therefore have a stake in these issues.

Statistical evidence suggests that scale economies in banking disappear beyond a fairly small size, although this evidence is far from conclusive (*3*). That is, most banks cannot reduce their average costs simply by growing bigger. If true, this characteristic of the banking industry has two implications for rural communities. First, "outside" banks need not pursue the purchase of rural banks as part of an attempt to become more efficient. Second, the absence of observed scale economies might be explained by the ability of small banks to provide low cost services through contracts with third parties.[8] That is, technology not only reduces costs, it also makes the benefits easily available to firms of all sizes. Thus, rural communities may be able to retain their locally owned and operated banks, yet not lose out on new services or lower costs made possible by technological advances employed by larger banks.

This scenario is not, however, a foregone conclusion. Many researchers remain unconvinced about the absence of scale economies. The database used in most studies was comprised of banks with assets under $1 billion (*3*). This database provides a technical basis for skepticism, because the giants of the industry invest most heavily in new technology. The studies may have been correct with respect to the study period, but things have been changing so fast that future research may come up with the opposite conclusion. Major players in the banking industry talk and act as if size is important, and many believe that a minimum size of $10-$20 billion in assets is required to compete successfully as interstate banking develops. Attesting to the strength of the belief that size matters, a group of large banking firms, commonly referred to as "superregionals," has developed over the past several years through mergers.

Less work has been done to search for possible economies of scope that lead to lower average costs as a bank introduces new financial products. For example, the same bank employee that handles the paperwork for a new checking account might be able to sell individual retirement accounts (IRA's) and savings accounts at a minimal increase in time, and the same computer can easily maintain these various accounts. Although the "financial supermarket" concept has not really succeeded because people seem to prefer purchasing certain services from traditional providers, cross-selling and developing strong customer relationships are being pushed by many banks and bank consultants as the key to future profitability.

Regulatory Change and Deregulation

Regulation of the U.S. commercial banking sector is complicated by the number of participants in the process. Because a bank can choose to operate with either a national or State charter, both State and Federal regulators are involved. Legislative and judicial branches at both levels of government are also involved in developing and interpreting bank regulations. Other interested parties from related industries (such as thrifts, brokerage firms, and insurance companies) try to protect their own interests

[8] The third party might be a large correspondent bank, a bankers' bank (banks chartered in some States to provide services to small banks), or some other firm large enough to invest in the required technology.

by lobbying all of the above, and the banks themselves are constantly testing the boundaries of existing regulations and lobbying for expanded powers.

At the Federal level, three agencies regulate commercial banks: the Comptroller of the Currency, the FDIC, and the Board of Governors of the Federal Reserve System. The Comptroller supervises banks with national charters. Besides providing deposit insurance for all covered banks, the FDIC also supervises State-chartered banks that are not members of the Federal Reserve System (membership is voluntary for State banks and mandatory for National banks). The Federal Reserve supervises State-chartered members of the Federal Reserve System and is responsible for bank holding companies.

Each State also has banking regulators with the authority to charter new banks and conduct examinations. State regulators and legislatures have led the way, initiating several important changes in banking. Negotiated order for withdrawal (NOW) accounts, for example, were first introduced in New England. Federal law makes true branching across State lines almost impossible, but States retained the power to permit their banks to be owned by banks in other States. During the 1980's, almost all States passed legislation governing interstate banking through MBHC's. The important action in the merger activity that followed has involved larger banks. Rural banks that changed hands in this process had probably already been owned by large MBHC's, because outside ownership was already a fact of life.

Financial deregulation has four major components: what products can be sold, who can sell them, where can they be sold, and at what price or interest rate. Each aspect of deregulation has potential benefits for rural areas by increasing the range of available alternatives or, in the case of interest rate deregulation, by lessening the possibility that credit sources will disappear. Interest rate deregulation has proceeded the furthest. Savers benefit through higher returns on their savings, and borrowers benefit to the extent that the availability of credit is more important than the price paid for it. Thus, when money becomes tight, banks and thrifts now have the ability to maintain deposit levels, and continue lending, by bidding against money market mutual funds.

In the near term, lessening the separation of banking and commerce will be the primary subject of deregulation efforts in the banking industry, but additional geographic deregulation will not be too far behind. Congress addressed the former issue in 1988, though without taking action, and will probably return to it in 1990. Large banks, especially, consider diversification into related fields, such as securities underwriting and insurance, as being critical to their survival in increasingly competitive global financial markets. Banks are losing market shares for traditional products, facing competitors with fewer constraints on where and what they sell. Large corporations sell commercial paper instead of borrowing from banks, and finance affiliates of the auto manufacturers have gained large market shares for car loans. At the same time, banks are forbidden from entering new, lucrative lines of business.

Integration of Rural Financial Markets

An important result of recent financial changes is that rural financial markets are now tied more closely to national and international financial markets. Whether one considers this integration good or bad, it cannot be ignored. If the foreign exchange value of the U.S dollar increases, exports of American agricultural products decline, and the rural effects are felt in both real and financial markets. If the prime rate of interest set by money center banks in New York City declines, rural firms and consumers pay lower interest rates on many of their loans.

Some ties have existed between rural and national financial markets for decades. These connections were especially present in States with statewide bank branching, because large banks often applied pricing policies uniformly at city and rural offices. The Farm Credit System provides a second limited example, in that it sold bonds to the national money market to raise the funds loaned to farmers. The federal funds market, in which banks sell or buy excess funds on a daily basis, comprises a third example. But small banks, including most rural banks, typically sell (or lend) federal funds. Hence, this tie had little effect on rates paid by rural borrowers, because the federal funds market was not a source of loanable funds, but rather an outlet for surplus funds.

The range of ties between rural and national financial markets is rapidly growing wider and stronger, however. Still, that does not mean that rural residents and firms will necessarily have equal access to the array of financial services and service providers available to their urban counterparts anytime soon. Some improvements in this area are likely. But, the more important effects may be seen with respect to economic volatility; changes in the general level of interest rates will be noticed just as fast in rural communities as they are in New York, Chicago, and San Francisco.

The secondary market for home mortgages has a fairly long history. Selling securities backed by a pool of mortgages allows loan originators to regain their liquidity, while giving investors a reliable flow of investment income. More recently, automobile loans and credit card receivables have been used as a backing for securities. "Farmer Mac" is gearing up to begin a secondary market for agricultural loans. Diversification lowers the inherent risk of investments, thus increasing the supply of mortgage money (or funds available to the agricultural sector) and lowering its cost. By purchasing pieces of many loans rather than one whole loan, investors do not face disaster in case of a single default. Geographic diversification provides further insulation because a recession in one region of the country only has a limited effect on the pool. However, the underlying loans must still satisfy strict underwriting standards. Investors are not likely to purchase securities backed by a pool of highly risky loans.

Rural Development Through Private Lenders?

Although trends toward greater concentration of financial resources will probably be less pronounced in rural markets, rural areas will clearly be affected to some extent. The small size of rural markets means that most are already highly concentrated in terms of the combined market share of deposits held by the three largest banks, for example (*1*). Large banks may have greater opportunities to develop staff expertise on a wider variety of financial services, but is that expertise applied in rural areas? Do rural-based banks lack the will and ability to provide similar services, either directly or through correspondent relationships with larger banks? These questions go to the heart of the banking industry's effect on rural development prospects.

Although solid evidence that might allow us to answer these questions with assurance is lacking, financial changes should have a marginally positive effect on rural credit delivery. Larger banks are looking at small businesses with renewed respect as big firms arrange more of their own financing directly through the commercial paper market. Rural banks may never be able to provide all the services of their giant city counterparts, but that is not necessary. In those cases where local banks are replaced by outside banking firms, borrowers may confront new obstacles such as greater paperwork and delays in judging some loan applications. Creditworthy loans will generally continue to be made, and the new lenders may accept some loan requests, either because of familiarity with a wider range of industries or by introducing innovative financing techniques, that their predecessors would have rejected.

Banks cannot be expected to bring about economic growth through their efforts alone. They can aid development by accepting creditworthy loan applications, giving technical assistance and advice to owners of young firms, and helping entrepreneurs identify governmental assistance programs in cases where loan applications are judged excessively risky. Top managers of a bank might take leadership roles in local development efforts, such as promoting the town as a good location to outside corporations planning to build branch plants. The bank might even participate more directly through vehicles such as a Small Business Investment Corporation (SBIC). But a bank should not be in the business of making loans with only marginal repayment chances. The community would benefit little if at all if the bank became so troubled that it could no longer meet normal credit demands.

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Chapter 3

Rural Nonfarm Businesses' Access to Debt and Equity Capital

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Local sources of debt and equity capital are adequate for most rural businesses. Small, new firms and very large firms, however, often have problems arranging credit through rural lenders. The firms experiencing the most difficulty in acquiring capital, after proper consideration of risk, are often those on the leading edge of rural development. Inadequate skills in packaging funds and assessing risk represent a substantial portion of rural nonfarm businesses' difficulty in acquiring debt and equity capital.

Introduction

Some observers have charged that rural areas lag behind urban areas in economic growth because of a shortage of capital (*15*).[1] Nonfarm business growth, now critical for most rural economies, is affected by the availability of vital resources, among them capital. With adequate capital, businesses can develop local resources, exploit new technology, and compete effectively with firms located elsewhere. Current rural conditions, to some observers, suggest that inadequate capital markets are hindering rural development.

Financial markets should perform adequately when all users have the same access to financial capital, after adjusting for the riskiness of specific firms (*16*). One of the functions of financial markets is to discriminate between good and poor capital requests. If a business has difficulty obtaining finance because it is risky or has a poor investment plan, the capital market should not be faulted. However, if businesses have difficulty obtaining funds for reasons that reflect excessive costs of acquiring and processing information or capital provider limitations (for example, small size or restrictive loan policies), then the financial market can be considered inadequate.

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[1] Italicized numbers in parentheses identify literature cited in the References at the end of this chapter. The terms rural and nonmetro as well as urban and metro are used interchangeably.

The data needed to ascertain if rural capital markets are performing adequately are not generally available. Public policies tend to be based on anecdotal data, incomplete information, and untested hypotheses.[2] In this chapter, we draw upon the available evidence from a number of economic analyses of rural capital markets in different geographic locations and phases of the business cycle to shed some light on rural nonfarm business access to debt and equity capital.

Based on extensive research on capital markets in rural Wisconsin and the analyses of other rural areas across the country, we conclude that financial markets are performing adequately for a high percentage of rural firms. Most rural nonfarm businesses appear to be well served by their financial institutions. Availability of capital is not a widespread problem, and no one type or stage of business will always have difficulty acquiring capital in all rural capital markets. Nonetheless, particular types, sizes, and stages of businesses may have difficulty acquiring sufficient capital in certain markets.

Market Segmentation

Several studies in the upper Midwest over the last 30 years indicate that small, rural banks have very limited geographic markets. Surveys conducted in 1956, 1963, 1974, and 1987 indicate that smaller banks make 70-95 percent of their commercial loans within their home city or county (*10*, *25*, *32*, *34*). Rural banks in Wisconsin keep 86 percent of their lending activity within 10 miles of their home office (*39*). For many rural banks, service areas are clearly defined and rigorously adhered to (*30*). Thirty-seven percent of the lenders in four rural Wisconsin counties said nothing would cause them to lend outside their home area (defined by a 15-mile radius). Thus, rural financial markets, particularly for smaller businesses, are distinct and geographically limited. If financial needs are not adequately served locally, they will probably not be served by capital sources in nearby markets.

Urban-Rural Differences

Businesses appear to be generally satisfied with the way their local banks meet their credit needs. In a survey of newly formed businesses, 82 percent of the urban respondents felt their local banks had met credit needs well

[2] Much of the early research on local capital markets was based on attitudinal surveys of financial institutions, businesses, or community officials regarding the availability of funds (*7*, *8*, *11*, *13*, *15*, *24*). A major problem with all cross-sectional empirical studies on market adequacy is biased sample selection. The firms that were not able to start up or failed due to inadequate financial markets do not appear in cross-sectional studies of businesses or lenders. To the extent that existing economic structure and business location are historical products of how capital markets function, cross-sectional data may fail to uncover existing financing gaps.

compared with 74 percent of the rural respondents (*33*). But, 25 percent of the rural respondents did not believe they could find the needed capital locally, compared with 20 percent of the urban respondents.

A study of new firms identified a significantly lower use of short- and long-term funds among rural versus urban firms, but no difference in the use of real estate or medium-term funds (*33*). That study did not detect any significant differences in loan denial rates among new rural and urban firms, but did find higher loan denial rates within isolated regions.[3] Rural and isolated firms were denied loans more frequently than urban and nonisolated firms because of the lack of collateral. The rural firms tended to receive smaller amounts and pay higher interest rates for short-term loans and received shorter maturities than urban firms for medium- and long-term loans. But rural and isolated firms were just as successful at borrowing for startup costs as were urban firms and firms that were not isolated, after adjusting for size (*23*).

Venture firms are not active capital sources in rural areas. Half of the 40 venture capitalists interviewed in the upper Midwest had not invested in firms located in rural communities (population less than 50,000), and a quarter had invested less than 10 percent of their portfolio in rural firms (*27*). Only a few of the smaller venture firms had 25 percent or more of their portfolio in rural firms, which translated into only one or two investments.

Hustedde and Pulver's survey of 318 firms seeking at least $100,000 of venture capital found that only 37 percent of the rural firms had succeeded in acquiring funding compared with 62 percent of the urban firms (*14*). That finding need not suggest that venture capitalists failed their potential customers if the quality of the requests differed. The data in that study did not permit identification of investment risk.

Rural and isolated locations appear to directly affect businesses' access to equity capital, lending criteria, and the level of commercial and industrial lending activity by local lenders, all of which may constrain the availability of capital for rural economic growth.

Importance of Lender Actions

Dreese's study of growing and lagging counties in the Southeast provided some early evidence of a positive link between economic growth, bank

[3] Isolated regions were those with scattered populations, containing no large urban communities, and with no major banking centers nearby.

activities, and the training and sophistication of bank officials (*9*). But he concluded that deposit growth leads loan growth rather than bank activity causing economic growth. Barkley and Helander reached similar conclusions (*1*).

A 1979 study, in contrast, demonstrated the effect bank lending (only a portion of the local capital market) had on changes in local per capita income and the effect changes in income had on demand and savings deposits, which in turn influenced loanable bank funds (*12*). Over a 4-year period, a 10-percent increase in the average loan balances of Wisconsin banks caused a 4-percent increase in the rate of change of county per capita income. In rural counties, a similar change in total loan balances yielded over a 5-percent increase in the rate of change in county per capita income.

Thus, the evidence is mixed on whether bank activity can generate local economic growth. However, the assumption remains that bank investment policies can exert substantial influence on the local economy and its vigor, especially in rural areas. Bank activities, by themselves, cannot generate local economic development, but they influence the direction and pace of development and can hinder growth by restricting the flow of capital to small rural businesses.

Dimensions of Rural Capital Markets Requiring Particular Attention

If a capital market is properly functioning, it discriminates among loan requests on the basis of the applicant's risk characteristics. But, research indicates that rural capital markets allocate funds based on nonrisk factors as well.[4] These nonrisk considerations highlight various dimensions of rural capital markets that could hamper rural development efforts.

Size of Firm

Most rural firms have fewer than 20 employees (*26*). Recent studies have credited small firms with generating major employment gains over the last decade or more (*5*, *21*, *22*). But many rural economies are still dominated by one or two relatively large firms. The rural dilemma is that the potential economic contributions for both smaller and larger firms may be constrained by inadequate local capital markets.

[4] For the most part, this section is based on an analysis of the results of a 1987 survey of 39 formal lenders and 815 nonfarm businesses in four rural Wisconsin counties. The database and model are fully described in (*34*).

Firm size influences rates of denial, underfunding, proportion of debt funds raised locally, and the proportion of firms believing local markets are inadequate. In the 1987 Wisconsin survey, firms over $500,000 in total assets were more likely to be denied a loan, receive a loan of less than the amount requested, raise a smaller share of their debt capital locally, and believe that the local market was inadequate than were smaller firms (total assets of less than $100,000). The analysis does not indicate a lack of difficulty for smaller firms; rather it points out that larger firms may face funding difficulties as well.[5] As firm assets decline in relation to lender size, the firm has a higher incidence of denial and more frequently holds the opinion that local capital markets are inadequate.

Rural capital markets thus present an interesting dichotomy. Smaller firms, especially those just getting started, and larger firms, at least in relation to local markets, have greater difficulty borrowing local funds. Large firms often have access to nonlocal capital markets, but firms exceeding $500,000 in total assets are not necessarily large enough to enter regional capital markets.

Sector of the Economy

While still more specialized than urban economies, rural economies are becoming more diversified. Thus, rural financial institutions must analyze funding requests from firms in industries with which rural lenders have had little prior knowledge or experience. In this situation, financial institutions can decline the application outright, send the applicant to another capital provider, seek outside help to evaluate the application, or make the staff investment necessary to judge the application's merits.[6] But when asked about their use of outside counsel to evaluate loans and the sale of loan participations, small rural banks indicated that these are not widespread practices (*39*).

The 1987 Wisconsin survey found lenders were almost evenly divided in their opinions about which sectors were the easiest and which were the most difficult to evaluate (table 1). Retail and service firms clearly dominate the types of firms that lenders find both easy and difficult to finance. Manufacturing firms were generally perceived to be difficult more often than

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[5] An earlier study found that smaller startup firms experienced higher rates of loan denial in rural and isolated areas than in urban areas (*33*).

[6] The lenders responding to the 1987 Wisconsin survey made the following recommendations to rejected applicants: seek professional counseling or assistance (69 percent); seek money elsewhere (66 percent); revise plan and come back (43 percent); increase equity base (43 percent); seek management assistance (43 percent); and explore other financing alternatives with us (34 percent).

easy to finance. Lenders probably experience greater difficulty with specific types of businesses within these broad sectors. Loan requests from a business with which the prospective lender has little or no experience are clearly more difficult to evaluate.

Results from the same survey indicate that firms in sectors that represent a larger share of the local economy are more likely to believe that the local capital market is inadequate. As the proportion of the largest local lender's portfolio devoted to a sector increases, the chance of a loan denial to that sector's loan applicants increases. This likelihood probably indicates a desire by local lenders to diversify their portfolios.

This evidence indicates that the sector of the economy and the size of business present parallel problems. Firms at the ends of the spectra seem to have the greatest problem in getting access to local capital. Those in unfamiliar industries and those in sectors with high concentrations experience difficulty. Those firms that are relatively small or very large have greater difficulty acquiring local capital.

Stage of Business Development

A review of job generation studies attests to the vigorous dynamics of local economies (*5*, *21*, *22*, *37*). Some firms start up or move into the area. Other firms fail, are absorbed, or move out of the area. Others expand or contract. The importance of each of these occurrences varies over time and among regions (*22*). If financial institutions are not actively involved in financing all of these different sources of change, they could be limiting local growth options.

For rural areas, the startup stage is particularly important because it represents the leading edge of local development.[7] A survey of rural Wisconsin lenders identified startup and preventure firms as the most difficult business development stages for rural lenders to evaluate, while **expansion and maintenance stages were the easiest (table 2).**

Size of Lender

The size of the lender affects the performance of the local rural nonfarm capital market in several ways. Size is directly related to individual lenders'

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[7] Raizen, Shaffer, and Pulver found that startup firms experiencing a loan denial eventually grew faster than those not experiencing a denial (*28*). They also found that 75 percent of the newly starting firms that were initially denied credit eventually acquired financing. Another study found that 18 percent of all surveyed businesses reported at least one denial and that fewer than 50 percent of these eventually acquired part of the funds requested (*34*).

Table 1--Rural lenders' opinions on the difficulty of financing nonfarm businesses, by sector

Sector	Easiest to decide		Most difficult to decide	
	Lenders	Share of all	Lenders	Share of all
	Number	*Percent*	*Number*	*Percent*
Retail	19	44.2	17	41.5
Wholesale	3	7.0	0	0
Manufacturing	4	9.3	8	19.5
Services	13	30.2	10	24.4
Construction	2	4.7	3	7.3
Transportation	2	4.7	3	7.3

Note: Respondents were allowed to provide more than one answer.
Source: (*34*).

loan limits, but it also appears to be linked to the lender's evaluation capacity and access to nonlocal capital (*7*). Smaller banks cannot afford to offer the full range of financial services because limited demand and staff resources often make it uneconomical (*6*).[8] On the other hand, small banks are often the most aggressive lenders, having the highest loan/deposit ratios, as illustrated by a survey of 137 banks in West Virginia (*7*).

Milkove found that, after he corrected for size differences, the loan/deposit ratios, loan/asset ratios, and profit rates of nonmetro banks having less than $1 billion in assets were comparable to those of urban banks (*17, 18*). He concluded that bank size explains bank performance in rural areas dominated by smaller banks, especially in States that do not allow branching. Another study found that bank size explained much of the variation in bank experience with larger, more complex business loans (*39*). That study also found that many larger banks had no loan sales, while 25 percent of the smaller banks surveyed had sold at least one business loan. Still, smaller

[8] Most studies suggest that there are minimal economies of size in commercial banking (*3, 4*). But, these studies may no longer be valid because of the rapid organizational and technological changes in banking (*36*).

Table 2--Rural lenders' opinions on the difficulty of financing nonfarm businesses, by stage of development

Stage	Easiest to decide		Most difficult to decide	
	Lenders	Share of all	Lenders	Share of all
	Number	*Percent*	*Number*	*Percent*
Preventure	0	0	14	35.0
Newly starting	0	0	21	52.5
Expanding	15	35.7	3	7.5
Maintenance	21	50.0	1	2.5
Change of ownership	6	14.3	1	2.5

Note: Respondents were allowed to provide more than one answer.
Source: (*34*).

banks tended to feel they had more problems placing loans that exceeded their legal lending limit.

The empirical evidence is mixed about the influence size has on lender behavior. Bank size apparently affects nonfarm commercial lending activity, but individual banks often break the pattern. Thus, the role of local bank management and boards of directors may be just as significant as bank size.

Level of Information

Information enters the capital allocation decision in two ways: the business firm's decision on how to use the funds and the evaluation skills of the capital supplier. One of the critical differences among capital providers is their ability to acquire and use information on prospective users of funds. Some of the more obvious differences include the length of the relationship between businesses and their capital suppliers, the suppliers' level of sophistication or experience in evaluating financing requests, and the ability of businesses to provide appropriate information.

A 1987 survey of rural Wisconsin lenders found that lenders had a business relationship for 5 or more years with 55 percent of their borrowers and had known another 34 percent of their business customers more than 1 year. They had worked with the remaining 11 percent for less than 1 year, but this group typically accounted for only a small part of their portfolios.

Commercial lending experience should improve the financial institution's ability to evaluate nonfarm business loan applications. But, banks in rural areas are less apt than urban banks to employ commercial loan specialists (*7*). In 1986, only 47 percent of nonmetro counties had a commercial lender, while 81 percent of urban counties did (*20*).

Another dimension of the information issue is lender experience with the particular type of firm requesting a loan. Measures of the level of information or experience among lenders were positively related to denial rates, proportion of funds raised locally, and perception of local market inadequacy (*34*). Thus lenders' experience increased the proportion of funds raised locally but also increased denials of loan applications. This action is undoubtedly related to a need to diversify the total loan portfolio.

The 1987 survey of rural Wisconsin borrowers indicates that as a borrower's management experience increases, the incidence of loan rejection declines, but so does the share of equity funds raised locally, and the perception of local capital market inadequacy increases. Thus, as the level of business knowledge increases, the complexity of capital requests apparently also increases.

Use of Funds

Several studies indicate that major difficulties occur in the acquisition of longer term funds when firms have little or no collateral. The *1987 State of Small Business Report* indicates that small firms rely more on informal and internal capital than do larger firms, use relatively less debt, rely more on commercial banks and short-term loans, use more secured credit, and do not avail themselves of the full range of available funding sources (*37*).

A 1980 Wisconsin study found that rural startup firms had significantly fewer long-term loans than did urban startup firms (*33*). The amount of short-term loans for rural startup firms was also less than for urban startup firms, but the major problem reported by respondents was the acquisition of long-term operating capital.

Ninety percent of the rural Wisconsin firms surveyed in 1987 reported no loans with a maturity exceeding 5 years. As in other studies, their primary sources of debt capital were short- and medium-term loans. Most of their individual loans were in amounts of less than $20,000. Only 24 percent of the firms indicated that they had an unsecured loan (and 50 percent of these had a secured loan from the same source). The unsecured credit was mostly short-term, with few maturities exceeding 2 years.

Intermarket Capital Flows

Those concerned about the export of funds from rural areas should remember that exported funds become the source of external capital for other areas (*31*, *35*).[9] The export of capital to larger financial centers may be necessary to lump capital into big enough units to service the credit needs of larger local firms. Capital exports should only be viewed as detrimental if lenders or investors are unaware of viable local opportunities or if the costs of making local investments are unnecessarily high.

Barkley and Potts note that branch banking and bank holding companies create a potential to move funds from nonmetro to metro areas (*2*). However, they found that funds apparently move among nonmetro areas rather than out of rural areas. Some observers have also suggested that the presence of multibank holding companies or branching could increase the local competition for funds and services in rural areas. However, Rogers' examination of operating ratios of unit banks and affiliated banks found most initial differences had disappeared within 3 years after affiliation (*29*). This finding could indicate that bank holding companies do not offer much longrun hope of increasing local banking activity and competition in rural areas or that they successfully invigorated the local independent banks. His data do not permit determining which is the accurate interpretation.

In addition to relying on formal organizational ties, rural banks have several ways of importing capital, such as loan sales, participations, syndications, and secondary markets. However, rural banks are not particularly active in seeking outside funds for local projects. About 60 percent of the 192 smaller rural banks responding to a 1984 survey relied almost exclusively on deposits as their source of loanable funds (*39*). Only 7 percent aggressively supplemented their deposits with outside sources of funds (primarily using loan sales and guarantees).

Fewer than 5 percent of the banks responding to the 1984 survey had sold or obtained guarantees for 10 or more loans (*39*). One of the barriers to using nonlocal sources is placing the loans in the secondary market.[10] Thirty percent of the Wisconsin respondents reported difficulties in placing overline loans because of pricing disagreements, paperwork problems, and questions about creditworthiness.

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[9] Funds also flow from smaller to larger rural banks (2). Banks seldom cross market boundaries to provide funds directly, but they frequently use indirect funding mechanisms (*30*).

[10] Loan guarantees do not appear to play as significant a role in intermarket capital flows as was initially believed. Over half of the loans sold by the Wisconsin study respondents were not guaranteed. And nearly half of the respondents' guaranteed loans were not sold (*39*).

The use of nonlocal capital sources by rural banks appears to be concentrated in a few banks and not available to many communities and businesses. This lack of proven experience in tapping outside sources of loanable funds can be serious, especially if the funds are crucial for rural economic development. The problem is further accentuated by the increased competition for deposits resulting from the deregulation of depository institutions. The traditional sources of debt financing for small business development, local demand and time deposits, are unlikely to expand much in rural communities.

Use of Equity or Venture Funds

A component of the rural capital market that has received little prior attention, equity or venture capital, represents a significant source of rural development funds (*40*). Surveys of new business starts in Wisconsin found that their equity capital structure was not overly complex (*28*). New business starts in rural areas are much less likely to use "borrowed" equity capital than their urban counterparts (*33*). This difference is especially pronounced between areas that are isolated and those that are not isolated from major urban centers. This pattern may reflect differences in equity needs among businesses, but rural firms might improve their access to equity capital by using more sophisticated equity capital mechanisms.

The primary source of external equity capital for small businesses appears to be informal investors, sometimes referred to as "angels." In a survey of 318 entrepreneurs who had sought equity capital in amounts of $100,000 or more, 59 percent were successful (*14*). Of those who acquired funds, 63 percent received funds from private investors located in the same State who were not formal venture capitalists or investment bankers.

Over half of the upper Midwest venture capitalist funds in that survey were invested in firms that were expanding and 36 percent of the funds were invested in new or relatively young firms (*27*).

Venture capitalists generally ranked information as very crucial in their disbursement decisions (*27*). Venture capitalists uniformly cited bankers, accountants, and attorneys as highly valued key informants who were often relied upon to screen potentially lucrative deals from those with little promise. To test bankers' knowledge of venture capital markets, Pulver and Hustedde surveyed all Minnesota and Wisconsin banks with assets over $24 million (*27*). Their findings suggest that the demand for equity capital is limited in nonmetro areas because less than half of the rural banks had been approached by clients seeking equity money (table 3). That conclusion could reflect few businesses needing large blocks of equity, but it could also mean

Table 3--How banks match those who need and those who have venture capital ($100,000 or more)

Item	How many responded positively?	Share of all surveyed
	Number	Percent
Banks contacted by clients seeking equity financing:		
Metro banks	24	66
Nonmetro banks	134	47
Banks aware of equity investors:		
Metro banks	27	77
Nonmetro banks	134	44
Banks that make actual referrals to equity investors:		
Metro banks	27	70
Nonmetro banks	127	29

Note: Respondents were drawn from all Minnesota and Wisconsin banks with assets exceeding $24 million. Metro banks are those headquarted in the Minneapolis, St. Paul, Milwaukee, and Madison metro areas.
Source: (*27*).

that businesses in rural areas are less knowledgeable about equity sources or less inclined to approach their local banks for information on equity money.

Nonmetro Wisconsin banks are generally unaware of equity investors and are unlikely to make a referral to an equity investor. A survey of 37 rural lenders identified 11 lenders who reported knowing people willing to make equity investments, but the other 26 lenders identified none (*34*).

Access to equity or venture funds in rural areas appears to depend on the business community's awareness of their existence, their investment objectives, and realization of how such funds can be used. This conclusion suggests that rather than capital rationing, the difficulty many rural firms have acquiring outside equity capital may be the result of insufficient knowledge about how to package financing requests.

Conclusions and Policy Implications

The studies and data reported above do not present a clear and obvious pattern regarding capital market adequacy in rural areas. Much of the research is inconclusive and subject to alternative interpretations, but some themes still emerge. First, rural capital market problems may be more a problem of how to assemble funds in nontraditional, more sophisticated manners rather than an absolute lack of funds. Second, acquiring long-term funding through either debt or equity remains difficult.

Access to capital (both debt and equity) by nonfarm firms is not a universal problem in rural areas. Most rural capital markets seem to function adequately for most nonfarm businesses. Instead, capital access problems appear to be specific to those firms on the margins of their local market. Those experiencing the most difficulty in acquiring capital, after proper consideration of risk, are often those on the leading edge of rural development. Thus, capital market adequacy for these firms is of special concern. Research suggests that

- The types of businesses that are new to a community often present special problems in loan evaluation.

- Firms in industries which dominate an area often have capital access problems as lenders become concerned about portfolio diversification.

- Smaller businesses with relatively small loan requests have difficulty in local markets dominated by large lenders.

- Large firms may also experience more difficulty in rural capital markets because their requests often exceed local lending limits or local lenders may not be willing to seek loan participations or guarantees.

- Entrepreneurs seeking financing for preventure or startup purposes experience difficulty in securing debt capital in most markets.

- Funding problems for high risk firms are more acute in rural areas because of limited access to external equity providers and to lenders willing to use loan participations and guarantees.

- Rapidly growing firms frequently encounter capital access problems.

- Long-term operating capital is a frequent problem when limited collateral is available for security. Although this situation is a problem for small businesses in general, firms in rural areas appear to have even less access.

- Because lenders in rural areas seldom extend debt capital to firms outside their service area (often as small as a 10- to 15-mile radius from the local office), borrowers have a limited number of choices in seeking capital. The greater the distance from the business to a population center, the more limited is the access to capital.

- Persistent rural firms facing local capital market difficulties often seek out alternative funding sources and mechanisms. Rural lenders generally provide less help to entrepreneurs seeking alternative sources of financing than do urban lenders.

In contrast, businesses in urban areas have access to many more sources of capital. Urban lenders have a greater diversity of enterprises in their market and develop a similarly diverse portfolio of loans. Urban firms in sectors dominating the local economy will have better luck in finding a willing lender. Urban entrepreneurs wishing to start a new type of business are more likely to find a nearby lender with experience in a related technology. Large urban firms can more easily find a large bank with which to deal.

Despite the disadvantages rural firms face, the problem of rural access to capital appears to be related to underuse of existing funding mechanisms rather than an absence of capital. With a better capacity to evaluate loan applications, rural lenders could be more aggressive in lending to unfamiliar businesses, to newly starting firms, and to rapidly growing firms. With greater understanding and use of mechanisms for distributing risk (such as equity capital, loan guarantees, and participations), lenders could be of greater assistance to both smaller and larger businesses, to firms in industries which are highly concentrated in the region, and to those with limited collateral with which to secure long-term loans for operating capital.

Policy Implications

Nothing in the research reported here necessarily justifies public intervention in rural capital markets. The fact that the capital needs of all rural businesses are not adequately served does not, of itself, support the implementation of public policies to rectify the situation. The full costs and benefits of public intervention determine the desirability of governmental involvement. But if policymakers wish to increase the supply of credit to rural businesses, the available research suggests possible approaches.

First, the evidence suggests that existing rural capital markets are providing adequate funding for most nonfarm businesses. Because most businesses express satisfaction with their local financial institutions, any adjustments to current financial regulations or other attempts to alter capital flows must not disrupt adequately operating capital markets.

Businesses on the margins of size, types of industry, stage of development, and rates of growth have the greatest difficulty in acquiring adequate capital in rural areas. The primary problem appears to be an inadequate flow of information between borrowers and lenders regarding business plan development, alternative sources of funding, loan evaluations, and mechanisms for distributing risks. Policy aimed at improving rural capital markets should, therefore, focus on the peculiar needs of these businesses.

Governmental provision of community education and technical assistance is one mechanism for increasing the flow of information of use in rural capital markets. Programs aimed at assisting individuals to improve the quality of their business plans and debt and equity requests would increase the likelihood of positive consideration by capital providers. Business management education and technical assistance would also benefit preventure and newly starting firms and entrepreneurs forming "unfamiliar" businesses.

Knowledge of the various sources of debt and equity capital, both within and outside the local market, would benefit businesses of all sizes. Aggressive borrowers frequently find the funds they need outside of their area. But rural firms are often handicapped by the lack of referral systems capable of directing them toward appropriate lenders and equity providers. Some form of clearinghouse performing this function might be useful.

Lenders often need assistance in evaluating unusual loan applications. A public mechanism for providing specialized technical assistance could help rural capital providers play a larger role in local development financing. For example, if an entrepreneur in a predominantly agricultural area presents a business plan and loan application to a small local bank for early stage financing of a computer software business, the lender will probably need help in evaluating the proposal. The government might identify someone (either public or private) who could help analyze the application.

Regardless of the worthiness of a loan application, a local lender or equity provider may need to disperse the risk. Several mechanisms are available to disperse risk (*38*). However, rural banks seem reluctant to use these mechanisms. Policy analysts might seek additional incentives or procedural modifications which encourage greater participation in guarantee programs and more active use of loan participations among banks. Particular concern should be directed at facilitating the provision of long-term operating capital in rural areas.

Other public initiatives might be considered, especially if improving the flow of information regarding capital distribution proves ineffective.[11] To be effective, public policy will necessarily be complex, involving various approaches and all levels of government. Policy must reflect the fact that rural capital adequacy problems are diverse. The firms experiencing difficulty in acquiring funding are small and large, unfamiliar and common, growing fast and just starting up, in remote regions with one or two small banks, and in regions with only large banks. Government actions can provide a capital environment that nurtures growth. That environment alone, however, cannot assure that rural areas will grow as rapidly as their urban counterparts. Rural capital initiatives must be part of a total body of effective rural development policy if that growth objective is to become a reality.

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[11] For a discussion of the approaches currently being considered at the Federal level, see chapter 5 in this report. Also see (*7*, *15*, *19*).

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Chapter 4

Financing Rural Governments

Richard Reeder and Clifford Rossi*

Local governments play a dual role in the development of rural economies. They provide basic public services and infrastructure to rural residents and businesses and they provide additional assistance to new and expanding rural firms. Their small size, narrow tax bases, high tax burdens, and limited access to capital markets leave many rural governments with insufficient funds for development policies. Federal, State, and local strategies are available to partially overcome these problems, but no easy solutions exist.

Introduction

State and local governments provide infrastructure and public services that enhance productivity in rural areas, thereby contributing to higher regional income. The resulting improved quality of rural life may also stimulate development by attracting individuals and firms to rural communities. Local governments may also encourage economic development through locally sponsored economic development strategies, including the provision of private-purpose tax-exempt financing for facilities used by businesses and firms located in the area.

There is much debate today on the relative merits of infrastructure, public service improvements, and other local development policies as vehicles for economic development. The source of financing for these various policy initiatives tends to be a less popular topic. The types of infrastructure and services needed and their expected effects on rural communities will be discussed in a companion volume to this report. This chapter examines challenges facing rural governments' financing of public services and Federal, State, and local strategies for addressing these challenges.

Many rural governments are hard pressed to provide sufficient funds for public services to households and businesses within their jurisdictions. Their problems vary from place to place and include the following:

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1. Their limited access to the municipal bond market makes it hard for rural governments to borrow funds at reasonable interest rates.

2. Their relatively low incomes, narrow tax bases, and the relatively restrictive statutory limitations placed on rural tax bases limit the ability of rural governments to raise taxes.

3. Their per capita costs of providing infrastructure and public services are relatively high (due to diseconomies of scale), resulting in higher tax burdens than in urban areas.

4. Their ability to identify and implement solutions to these problems is hampered by the limited staff, expertise, and leadership of rural local governments.

Recent Federal tax reform, financial problems in the farm and energy sectors, and declining Federal aid only exacerbated these problems in the 1980's. Some strategies might overcome these difficulties, but no easy solutions exist, and some of the strategies involve tradeoffs with other policy objectives.

Tax-Exempt Bond Market

Most locally financed public infrastructure projects involve the sale of long-term, tax-exempt bonds. Both urban and rural governments enjoy an indirect Federal subsidy through the exemption of interest on their obligations for Federal tax purposes. Between 1966 and 1985, for example, the tax-exemption reduced local government borrowing costs by 25 to 35 percent from equivalent taxable rates (*25*).[1] State and local governments issued $132 billion of long-term bonds in fiscal year 1987. By year's end, total outstanding State and local government debt was $719 billion, $2,953 per person (*27*).

The tax-exempt bond market is a major source of funds for both urban and rural governments, but rural governments tend to have more problems gaining access to this market.[2] Rural government borrowing problems are associated with factors such as the small size of rural communities, inadequate information in the bond market, and new restrictions imposed

[1] Italicized numbers in parentheses identify literature cited in the References at the end of this chapter.

[2] Despite evidence showing that the creditworthiness of rural governments may not be rated as highly as urban governments, rural municipalities borrowed at rates comparable to urban borrowers on publicly offered debt (*11*).

by Federal tax reform. These borrowing constraints affect the size, type, and timing of infrastructure projects.

Local governments often face statutory limitations on general obligation bond issues. Limits often tie a community's ability to issue debt to the assessed value of taxable property within the community. Such restrictions protect a local government's fiscal integrity, but they may contribute to service delays for rural communities experiencing declining property values or rapidly growing infrastructure needs.

Tax Reform Act of 1986

The market for municipal securities was greatly affected by the enactment of the Tax Reform Act of 1986. The new tax provisions influenced both the demand for and the supply of tax-exempt securities. On the supply side, the new tax law established tighter limits and restrictions on the issuance of tax-exempt bonds. On the demand side, the lowering of marginal tax rates and the repeal of banks' deductibility of interest associated with their tax-exempt bond holdings have increased the relative cost of investing in the tax-exempt bond market.

The 1986 Act distinguishes between bonds with a governmental purpose and private-activity bonds. The former account for about 39 percent of the municipal bond market and their tax-exempt status is left intact under the act (*12*). Certain classes of private-activity bonds have either lost their tax-exempt status or are subject to volume restrictions. More restrictive definitions of public-purpose activities also result in higher costs for rural communities in cases where a single large private user of a bond-financed project disqualifies the issue from the public-purpose tax-exempt category.

The demand for tax-exempt securities by commercial banks, historically large investors in this market, has been significantly affected by tax reform. At the end of 1985, banks held 35 percent of the outstanding State and local debt. By the second quarter of 1988, banks' holdings had slumped to 22 percent (*15*). Contributing to the decline in bank demand for tax-exempt securities was the repeal of the deduction of interest expense attributable to the purchase of tax-exempt securities, combined with the drop in marginal tax rates and a new minimum tax that applies to interest earned on municipal bonds. To avoid the high costs of selling in the national bond market, rural communities tend to borrow from local sources, typically local banks. Hence, the effect of the 1986 Act on local banks could be more harmful to rural issuers than urban issuers. The small-issue provision in the act exempted offerings of less than $10 million to offset this problem for rural governments (*14*).

Other provisions of the 1986 Act affecting the tax-exempt bond market include restrictions on arbitrage and advance refundings and new recordkeeping requirements. Many rural governments accumulate funds from tax collections and user charges to finance the construction of public infrastructure. For example, one survey found half of rural communities financed all or part of their water system capital improvements through "internal financing." Bonds and commercial loans were used by only one-fifth and one-tenth of rural communities, respectively (*24*). Tax reform tightened the arbitrage restrictions on these securities implying lower returns on investments as well as smaller issues and burdensome recordkeeping requirements. Advance refunding allowed local governments to refinance outstanding debt with new issues before the refunded debt's retirement. The restrictions of the 1986 Act on advance refunding will push up debt financing costs for local governments. Rural communities with their limited staffing resources will be challenged more than urban borrowers by recordkeeping requirements.

State Assistance in the Bond Market

Some States provide financial and nonfinancial assistance to rural governments in issuing securities. These programs may be justified on efficiency grounds to the extent that they offset informational deficiencies in the market that result in excessively high borrowing costs for small local governments. State intervention in the tax-exempt bond market varies. Programs range from grants to help pay local government debt service to technical assistance programs geared toward educating local officials about procedures for financing local projects. Much of State assistance consists of loan guarantees, bond banks, and revolving loan funds.

Loan guarantee programs pledge repayment of local debt in the event of government default. State acceptance of liability lowers borrowing costs for localities. The degree of liability facing individual States under these arrangements varies considerably, as does their effect on borrowing costs. State bond banks pool the financing needs of many local governments into one large bond issue to obtain economies of scale and improve credit ratings, lowering interest costs. The most common form of pooling is when a State-sponsored agency borrows funds which are relent to participating local governments. Nine States have general purpose bond banks, and many special purpose credit programs also exist (*13*). Some States provide similar assistance through revolving loan funds. Initial capitalization for such funds comes from Federal or State appropriations or revenue bonds. When loans are repaid, these funds are "revolved" to make additional loans.

Not all rural governments benefit from these programs. A local government must typically justify its need for State aid and demonstrate sound financial management practices to receive assistance. These requirements may deter some rural communities despite the potential benefits of participating.

States also provide various forms of nonfinancial technical assistance to local governments. State training programs improve accounting practices, provide information on how to issue securities, develop financial management techniques, and evaluate alternative revenue-raising methods. Such programs benefit small communities that lack the manpower, time, and expertise to sufficiently evaluate alternative financing techniques.

Creative Financing

Although most rural governments do not employ sophisticated creative financing techniques, innovative alternatives to standard debt financing may provide additional relief to enterprising rural governments. For example, creative debt instruments have been designed to lower interest expenses or improve cash-flow positions. Among the types of creative long-term debt instruments currently in use are zero coupon bonds that do not pay interest until the bond matures.

Some of the most innovative financial arrangements have occurred with nondebt sources of capital. Some local governments have leased public facilities rather than purchase them. A tax-exempt lease-purchase agreement permits the lessor to earn tax-exempt income from interest payments made by the local government or take advantage of various credits and depreciation deductions. This arrangement enables the community to acquire a public service without technically incurring indebtedness. In some instances, private investors have purchased public facilities from local governments to take advantage of tax benefits that cannot accrue directly to the municipality. The community then leases back the services from that facility, presumably sharing some of the tax savings through lower lease payments. The attractiveness of private ownership of public facilities has been essentially eliminated by changes in the tax code that swept away many of the tax advantages that made these arrangements work. As a result, operating contracts remain the most attractive type of leasing arrangement for local governments.

Rural Infrastructure Needs

The extent of unmet infrastructure needs facing rural governments cannot be estimated with any degree of precision with currently available information. Nonetheless, substantial sums of money are probably needed to adequately address the most pressing rural infrastructure problems. Examination of the conditions of infrastructure for water collection, treatment, and distribution (*19, 24*), wastewater treatment (*20*), and highways and bridges (*28*) all indicate widespread problems in rural America.

Rural infrastructure problems can be divided into two broad categories, deterioration of existing facilities and requirements for new or upgraded facilities. The budget problems State and local governments faced during the 1980's significantly worsened the physical condition of many existing facilities. As local government fiscal stress worsened, funds were often shifted out of infrastructure maintenance budgets to meet more visible public service needs. Deferring maintenance seldom results in immediate infrastructure problems, but the failure to complete preventive maintenance sooner or later results in irreversible damage and drastically shortens the useful life of infrastructure (*19*). Thus, infrastructure deterioration caused by cutbacks in the 1980's could increase future infrastructure demands as facilities begin to fail, requiring costly repairs or, in extreme cases, complete replacement.

Rural governments are also under pressure to provide new and better public facilities. Local governments must meet dramatically increased maintenance requirements when providing certain services as Federal and State governments have mandated that steps be taken to monitor and correct environmental hazards through clean water, groundwater, solid waste disposal, and asbestos-removal legislation. These mandates often require rural governments to provide infrastructure that was not previously provided or to dramatically improve the performance of existing infrastructure systems. Court orders and threat of litigation have also forced local officials to increasingly adopt "urban" standards as minimums for rural infrastructure projects, often adding to their complexity and cost. Thus, growing and declining rural communities alike often have substantial backlogs of infrastructure projects awaiting financing.

Local Taxes and User Charges

The ability to finance local infrastructure and public services, whether through borrowing or with current appropriations, ultimately hinges on the local government's ability to raise revenues. If rural governments are to foster economic development, they must confront two related weaknesses in their tax bases. First, rural communities heavily depend on property taxes which have been unpopular in recent years. Second, rural governments tend to make only limited use of other taxes and user charges, increasingly important revenue sources for local governments nationwide.

Local governments in rural areas (nonmetro counties with no towns above 2,500 in population) collected almost three-fifths of locally raised general revenues from property taxes in 1982 (*16*).[3] In contrast, local governments in most urban areas (both metro counties and nonmetro counties with towns having 2,500 or more residents) rely on property taxes for less than half of their own-source general revenues. Heavy reliance on property taxes has the advantage that local officials can usually change tax rates to maintain stable or moderately growing budgets without explicit voter approval. This limited flexibility enhances short-term fiscal stability and probably explains why the recent farm crisis did not generally result in immediately reduced local public services (*10*).[4]

The stability of property taxes may help local governments maintain revenues and expenditures during times of economic difficulty, but property taxes may also raise the ire of local taxpayers, who experience significant increases in tax burdens (taxes as a percentage of income) during periods of declining incomes or when assessed values increase faster than incomes. Taxpayer revolts tend to make the property tax an inflexible revenue source over the long run, not well suited to financing major increases in infrastructure or public services. Rural officials may have difficulty winning approval of bond referenda for improvements in local public services or surviving calls for tax rate hikes.

"Classified" or "use-value" assessments may further depress rural government property tax collections (*18*, *26*). These State-imposed tax breaks for farmland are designed to preserve the agricultural character of rural America. But, they may do so at the expense of reduced property tax collections. They also discourage economic diversification, which may depress rural economies over the long run.

Both the resistance to local taxes and the demand for farmland tax breaks might be eased by shifting from property taxes to other taxes and user charges. Local governments nationwide, both urban and rural, have been moving in this direction for many years. However, rural governments are more limited by State law than urban governments in raising such other revenues. Some States preclude small municipalities from adopting local sales and income taxes (*6*). States may also require voter approval before any new tax can be imposed by rural governments, making revenue diversification difficult in smaller communities.

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[3] All figures cited in this section refer to fiscal year 1982.

[4] Another advantage of the property tax is that it enables some communities, particularly mining and energy communities, to "export" taxes to nonresident landowners, thereby reducing the tax burden on residents (*3*). But even if residents pay, they may still be able to "export" the costs through higher product prices in noncompetitive markets.

In 1982, rural governments raised less than half the revenues from other taxes (on a per capita basis) collected by urban governments (*16*). Rural governments collect user charges and fees but not to the extent that urban governments do, probably because rural governments generally do not provide as many of the services that residents can be asked to pay user charges for.

High Tax Burdens/Low Fiscal Capacities

Because of diseconomies of scale in the provision of public goods and services in small, thinly populated communities, rural governments impose among the highest tax burdens in the country. Local taxes and user charges (own-source general revenues) took up 7.5 percent of personal income in rural counties that were not adjacent to a metro area in 1982. Average tax burdens were much lower in other areas (fig. 1). High rural tax burdens present two distinct problems for rural communities: they stifle growth of new and existing firms and discourage firms and individuals from locating in rural areas, and they create hardship for taxpayers, who may resist additional investment in public infrastructure and public services in rural areas.

In counties that are adjacent to metro areas, local tax burdens are relatively low, but there may be significant opposition to local government taxes and spending.[5] Many of the residents of these counties commute to nearby metro areas to work or shop. In doing so, they pay taxes not only in their own jurisdictions but also to metro governments, either directly through commuter, sales, and excise taxes, or indirectly through wage reductions or price increases. Paying taxes to more than one local government may heighten taxpayer resistance to tax increases within their own jurisdiction.

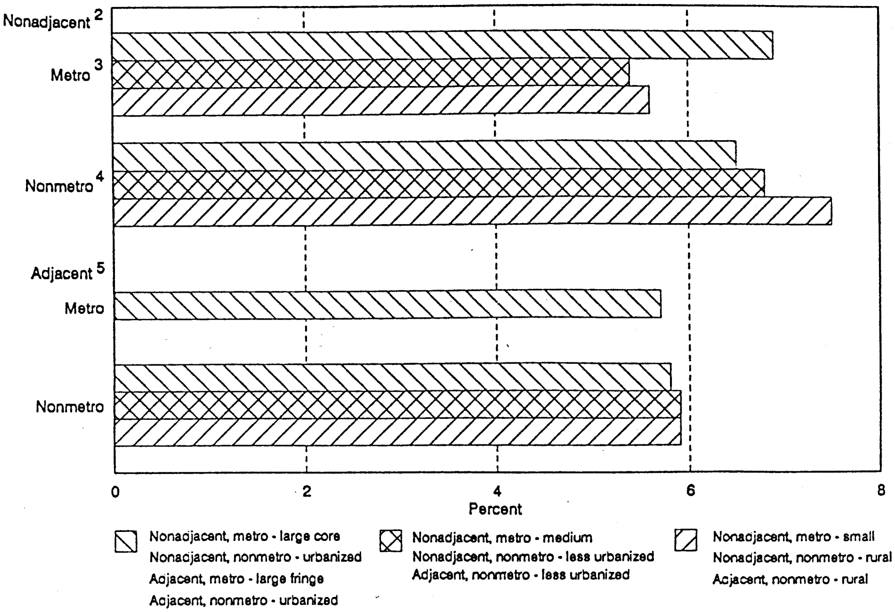
Inadequate local tax bases also limit rural government finances. The average nonmetro tax base, measured by per capita income, is one fourth less than for metro areas. In nonmetro poverty counties, fiscal capacity is only about half that of large metro counties (table 1). Nonmetro poverty counties have difficulty imposing even relatively low tax rates because many of their residents can only afford the most basic necessities of life. Poverty counties consequently spend far less on local government than do other counties.

Added to these traditional fiscal challenges are several new ones. Rural economies declined in many places during the mid-1980's, reducing local tax bases. Most rural counties have been losing population in recent years,

[5] Note that the suburban metro (large fringe) counties are considered here to be adjacent because so many of their residents commute to nearby central cities. Other metro counties (large, medium, and small) contain their own central cities and hence are considered nonadjacent.

Figure 1

Local government tax burdens for urban and rural counties, 1982[1]



[1] This comprehensive measure of local tax burden is total local own-source general revenues as a percentage of local resident personal income. See table 1 for an explanation of how this was computed.

[2] Nonadjacent counties include nonmetro counties not adjacent to metro counties and large "core," medium, and small metro counties.

[3] Large metro areas have populations greater than 1 million. "Core" refers to counties containing the central city of a large metro area. "Fringe" refers to suburban metro counties surrounding core counties. Medium metro areas have populations of 250,000-1 million. Most small metro areas have populations of 50,000-249,999; some have populations less than 50,000.

[4] Urbanized counties have 20,000-50,000 urban residents; less urbanized counties have 2,500-20,000 urban residents; rural counties have fewer than 2,500 urban residents (no towns with more than 2,500 population).

[5] Adjacent counties border a metro county and have at least 1 percent commuting to the central city of the metro county. Large fringe metro counties are included in this category as well.

Source: U.S. Department of Commerce, Bureau of the Census and Bureau of Economic Analysis.

leading to higher per capita costs for public services. Meanwhile, declining Federal aid, together with new, more stringent Federal requirements (such as recent drinking water standards issued by the Environmental Protection Agency) and new State mandates (such as requirements associated with education reform), mean fewer funds available for local discretionary purposes.

Table 1--Local government finances in metro and nonmetro areas, 1982

Type of county	Tax burden[1]	Tax base[2]	Expenditures[3]	Federal aid[4]	State aid[5]
	Percent	--------------*Dollars per capita*--------------			
Metro[6]:					
Large core	6.9	12,174	1,255	143	479
Large fringe	5.7	11,283	877	49	346
Medium	5.4	9,794	866	59	346
Small	5.6	9,675	867	68	345
Nonmetro[7]:					
Farming-dependent	6.8	9,125	971	55	390
Manufacturing	5.8	8,269	863	53	359
Mining and energy	8.0	9,323	991	57	396
Retirement	5.8	8,088	809	52	358
Poverty	4.5	6,122	671	63	403

Note: Data are unweighted averages of county-area measures. For example, to compute tax burden, first the total amount of local own-source revenue raised by all local governments within the county is computed for each county area. This total is then divided by total personal income for the county area to calculate the county's tax burden. The simple mean of these individual county measures is reported on the table for each type of area. This computational method is also used for figure 1.

[1] Locally raised general revenues as a percentage of local personal income.

[2] Per capita personal income, 1982.

[3] Current general expenditures, per capita.

[4] Excludes Federal aid that passes through State governments.

[5] Includes Federal aid that passes through State governments.

[6] Large metro areas have populations greater than 1 million. "Core" refers to counties containing central cities. "Fringe" refers to suburban metro counties surrounding core counties. Medium metro areas have populations of 250,000-1 million. Most small metro areas have populations of 50,000-249,000; some have populations less than 50,000.

[7] In farming-dependent counties, farming contributed an average of 20 percent or more of income during 1975-79. In manufacturing counties, manufacturing contributed 30 percent or more of income in 1979. In mining and energy counties, these industries contributed 20 percent or more of income in 1979. In retirement counties, 15 percent or more of the expected 1980 population or residents aged 60 or older moved into the county during 1970-80. In poverty counties, per capita income was in the lowest quintile in each of the years 1950, 1959, 1969, and 1979. Some overlap exists among the nonmetro categories, and some nonmetro counties do not fit into any of the categories.

Source: U.S. Dept. Agr., Econ. Res. Serv., from data provided by U.S. Department of Commerce, Bureau of the Census and Bureau of Economic Analysis.

Local Cost Cutting Strategies

Rural governments have only limited revenue options and often face stiff opposition to tax increases. Thus, cutting costs has been one of the most common methods for freeing up funds for improvements in public goods and services. One approach reduces costs by achieving greater economies of scale through consolidation or joint provision of services. For example, significant savings may be achieved by cooperative agreements among local governments for road maintenance (*3*), landfills (*7*, *9*), and other public services. In some cases, combining volunteer effort and joint provision, such as in emergency medical and fire protection services, may be the best option for small and declining rural jurisdictions with no other alternatives (*7*). Saving on costs by contracting services with the private sector is another alternative that is frequently used by rural governments.

The potential for additional savings from these cost-cutting approaches is limited in most cases, however. Almost half of nonmetro local spending is on schools. School busing is already extensive in rural areas and most of the likely school consolidation has already been achieved. Many rural communities already employ volunteers to provide police and fire protection and leave it to their residents to provide for their own garbage disposal (in public dumps), water supply (well-water), and wastewater disposal (septic tanks). Most rural governments already contract out what little they do that is not in the form of traditional public services (such as legal work when the government is being sued and architectural or engineering work for altering facilities to meet new safety and environmental standards).

A potential problem with cost sharing and contracting is that they usually involve a loss of local control. Some innovative cost-saving approaches do not. Among these are energy conservation (*2*), telecommunication in schools, and new, low-cost designs for rural infrastructure (*21*, *4*). However, these approaches often require leadership and expertise not readily available to many rural governments.

In some cases, funds can be saved by cutting back on selected, nonessential services. For example, reducing maintenance of lightly traveled roads can achieve significant cost savings in some farming areas where population decline and farm consolidation has reduced or eliminated the need for many of the old roads leading to now defunct farms (*4*). However, political opposition to such approaches can be stiff, even if only a few individuals use the roads in question.

Local Economic Development Strategies

Local economic development policies may also produce additional revenues for rural governments. For example, policies that attract high-wage firms, tourists, or retirees into the area can increase the tax base. However, these policies, especially those that rely exclusively on publicity and tax concessions to businesses, do not always succeed. Potential inmigrants often demand urban amenities such as high-quality public services and infrastructure. Hence, successful economic development policies usually involve substantial investments in local infrastructure. Even successful development policies, therefore, may not lower tax burdens for current residents if tax concessions are used to attract firms or if current residents must pay for infrastructure used by newly arriving firms and residents. Measures can be taken to reduce these problems. Tax concessions to firms can be linked to guarantees that the firms provide specified numbers of jobs within the community. Communities can also charge new residents or developers for the infrastructure they require through special benefit assessments, tax increment financing, and impact fees (*1*, *5*, *23*). These measures are particularly useful for rapidly growing rural areas, such as nonmetro retirement counties.

Federal and State Assistance

Federal and State governments play a major role in financing local government expenditures. Intergovernmental revenue accounts for a third of total local revenues nationwide and more than two-fifths of local revenues for most nonmetro areas (*16*). Federal and State governments also provide some functions directly to rural residents, such as health, retirement, and welfare programs, thereby relieving local governments of these responsibilities. The most significant aid for rural governments, however, has been associated with education and infrastructure.

State aid pays for more than half the cost of local education. Much of this aid goes disproportionately to poor communities, largely because of court-imposed equalization formulas. This aid plays a major role in sustaining education in many rural areas where tax bases are so low that the governments cannot afford to maintain basic service levels.[6] Other forms of State aid are not particularly targeted to distressed rural communities, especially general fiscal assistance that merely returns State revenues to the local areas where they originated. Nevertheless, total State aid patterns

[6] The number of such government-poor counties declined significantly during the 1960's and 1970's, but some observers fear that recent rural economic problems may have reversed this pattern of improvement (*15*).

appear to reflect the relatively high fiscal needs of rural governments. Nonmetro counties generally receive more State aid per capita than metro counties, and rural poverty counties receive more State aid per capita than other types of counties. Large core metro counties are an important exception, however, because they receive the highest per capita State aid nationwide (table 1).[7]

Federal aid has historically played a major role in financing rural infrastructure. Much of that aid was originally provided directly to local governments. Since the late 1970's, Federal budget cuts have terminated some direct Federal aid programs (such as general revenue sharing), while others have been cut back or converted into block grants to the States. Rural governments continue to receive significant funding from some remaining Federal programs (including education aid and Community Development Block Grants), but this aid is generally channeled through State governments. With direct Federal aid reduced, rural governments must look to the States for more financial assistance. Rural States, however, have also suffered from sectoral economic downturns, and significant increases in State aid may have to await better times for many rural governments.

The form of assistance may be as important to development prospects as the total amount received. Much Federal aid to rural governments has historically been in the form of loans or loan guarantees, a less valuable form of assistance than cash grants, especially for low income communities that cannot afford to make loan payments (*8*). The recent conversion of EPA grants into State revolving loan programs after many urban water quality problems were resolved and just as smaller, rural communities were receiving attention, only reinforces this discrepancy in the form of assistance received. To save on costs to the Federal Government, more programs now have local funding matching requirements or costly regulatory requirements that low income rural communities cannot meet. Many rural governments also are disadvantaged by programs requiring grantsmanship skills, since they lack the skilled staff needed to prepare project applications.

Federal and State Aid Strategies

Several strategies can improve the way intergovernmental aid is used to finance rural governments. For example, State governments can better target their assistance based on local government needs and ability to pay. Given the lower service level provided by most rural governments and higher tax burdens, rural areas would benefit from targeted assistance for economic

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[7] See Reeder (*17*) for an explanation of this phenomenon.

development, education, and highways. Rural areas would also benefit from State "rainy day" funds that allocate special assistance to local governments experiencing unexpected revenue instability, such as affects boom towns and other localities with narrow and unstable tax bases. To offset the adverse effects of Federal aid reductions, Federal programs could also be targeted to aid State and local governments with unmet infrastructure needs and low fiscal capacities.

Other strategies could reduce rural government costs and increase their chances of participating in development programs. For example, Federal and State governments may consider relaxing mandates that cause excessively high costs for rural governments or compensate rural governments for those costs. Relaxing local matching requirements for low income communities, possibly through a sliding-scale matching requirement, would help rural governments that have trouble raising the required funds. State and Federal agencies could also provide more management and technical assistance to rural governments, helping them implement sound financial and economic development strategies so that scarce tax dollars are not wasted.

Conclusion

Financing rural government has always been a challenge. Due to the lack of economies of scale for many rural communities, rural infrastructure and public service costs are generally high. Rural tax bases tend to be small and tax burdens high. Heavy dependence on property taxes adds to taxpayer resistance to rural government tax and spending increases. Rural local governments may also have difficulty borrowing funds for capital improvements. Recent economic and demographic problems and declining Federal aid magnify these problems. Consequently, many rural governments have faced increasing difficulties in raising funds for infrastructure and local economic development purposes.

Formidable though these problems may seem, strategies are available to help overcome them. At the local level, three types of strategies stand out: revenue diversification, cost cutting, and economic development. However, these strategies may offer only limited benefits, they require local leadership and expertise, and they may not work everywhere. At the Federal and State levels, various strategies might alleviate rural government financial difficulty. Steps that can be taken include improving rural government access to the municipal bond market, relaxing restrictions on rural government authority to tax and borrow, better targeting of intergovernmental aid to distressed communities, replacing loans with grants, and relaxing matching and regulatory requirements to reduce costs and increase rural participation in economic development programs. More information and technical assistance are also needed to assure that public funds are well spent.

Although strategies that help rural governments to reduce costs and raise more revenues may be viewed as largely complementary to other rural development strategies, some of the strategies involve substantial tradeoffs with respect to other policy goals. For example, easing Federal restrictions on the sale of tax-exempt private-purpose debt in rural areas would help some rural communities in their economic development efforts, but it would substantially reduce Federal tax revenues and would add distortions in the tax code that might lead to an inefficient allocation of resources. Replacing loans with grants for infrastructure projects would enable more poor rural communities to build infrastructure needed for rural development, but, unless proper supervision and technical assistance is provided, some of these infrastructure projects might end up costing the communities more in maintenance than they can afford. Relaxing Federal clean water mandates might reduce local government costs and free up funds for economic development purposes that could create more jobs for rural residents, but such a move would increase health risks for rural and urban residents. Rural governments might increase local revenues by removing preferential treatment of farmland under current classified or use-value property taxes, but this action could conflict with efforts to preserve the agricultural character of rural America.

If rural development policies are to succeed, Federal or State action may be required to help finance rural governments. Infrastructure and public service levels have long been inferior in poor and isolated rural areas, making it difficult for these places to attract new firms. Recent developments have even complicated efforts by relatively well-off rural communities to maintain, much less improve, their public services and infrastructure. Local officials have only limited means to deal with these problems. Without some form of assistance from higher levels of government, many rural governments may ultimately fail in their economic development efforts.

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Chapter 5

The Federal Role in Financing Rural America

David Freshwater*

There is strong economic justification for the Federal Government to continue supporting rural development. But, its role is likely to change as Federal budget deficits, political beliefs, and rural economic conditions evolve. Many agencies that previously financed rural development programs have adopted strategies that provide support by encouraging private lenders to supply the needed funds. And current policy initiatives generally call for the Federal Government to play an indirect role in financing rural business and infrastructure investment.

Introduction

A main thrust of past Federal rural development activity has been financial assistance to rural areas. Many such programs were initially developed during the 1930's in response to the Great Depression. Grants and credit programs are the most common, but over time various other approaches have been implemented. As financial markets evolved, the needs of rural areas changed along with perceptions about the economic role government should play. As a result, the mix of financial assistance programs also changed. Recently revived interest in rural development has led to renewed proposals to provide financial assistance to rural businesses and governments.

Federal intervention in financial markets has been justified on the same two grounds used for all forms of intervention: market failure and social welfare (*10, 18*).[1] Market failure arguments contend that imperfect capital markets provide less than adequate amounts of capital to rural entities. Imperfections include inadequate information, lack of competition, and high transaction costs. Social welfare arguments allow nonmarket criteria to play a role in determining the best allocation of capital. Even if the market is economically efficient, society may be unhappy with the outcome. The

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[1] Italicized numbers in parentheses identify literature cited in the References at the end of this chapter.

specific arguments for Federal involvement in development finance are subject to change, but the two basic issues of market imperfections and redistribution remain at the heart of Federal intervention.

Federal financial assistance benefits three broad groups: households and consumers, private businesses, and local governments and other providers of public facilities and services. Virtually all Federal economic development initiatives considered in this chapter assist businesses, governmental agencies, or quasi-public organizations.

Types of Federal Financial Assistance

Federal financial assistance can take many forms.[2] Although there are a number of ways to classify the various methods, one approach uses the budgetary consequence of each program. Increasing concern over the Federal deficit places the budgetary effect of Federal programs under increasing scrutiny. Programs requiring direct budget outlays and those creating future obligations are less favored than those promising smaller budget outlays. Figure 1 shows the budgetary consequences of various means of assistance, with direct grants, which have the most immediate budget consequences, at one end of the spectrum and a pure market allocation at the other end.

Grants

Grants to individuals, businesses, and communities eliminate or reduce the need to borrow funds in capital markets. Because grants involve no repayment, they place minimal burdens on recipients. Grants have been provided to low income communities and to rural businesses to offset perceived financial and other market inadequacies. Major grant programs for rural areas are operated by the Farmers Home Administration (FmHA) for sewer and water projects in low income communities, by the Economic Development Administration (EDA) for public works and development facilities, by the U.S. Department of Labor for job training, and by the U.S. Department of Housing and Urban Development (HUD) for community development.

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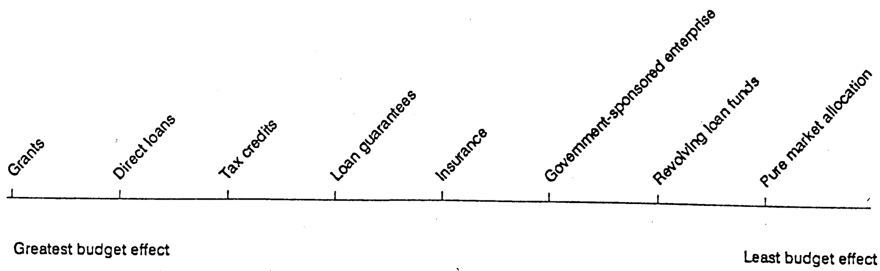
[2] Several recent reports examine the role of Federal programs in rural areas. The most comprehensive source is the *Catalog of Federal Domestic Assistance* which describes all Federal domestic programs but does not specify their effects in rural areas (*12*). Both the U.S. Department of Agriculture and the U.S. General Accounting Office have recently released reports identifying Federal programs of particular relevance to rural areas (*19*, *20*).

Figure 1

Federal financial assistance programs as they affect the Federal budget



Direct Loans

Direct loans by the Federal Government have made an important contribution to rural development. FmHA loan programs for farms, housing, and community development were established to provide financing to rural borrowers unable to acquire affordably priced credit from private lenders. The Small Business Administration (SBA) initially relied on direct loans to foster the creation and expansion of small business firms that could not raise funds from commercial lenders.

Tax Preferences

Unlike direct loans and grants, which are provided to specific individuals, businesses, or communities, tax credits or tax exemptions benefit any entity meeting eligibility qualifications. Because tax credits result in lost income for the Government, they have the same fiscal effect as an outlay. Tax exemptions, such as the capital gains exemption, only provide benefits when taxable income is generated. Thus, their value increases as an individual's or business's taxable income increases. Investment tax credits have been used to stimulate capital investment, and tax credits have recently been proposed as a way to improve access to day care.

A potentially useful tax exemption for rural development financing occurs through the issuance of municipal bonds. Tax-exempt bonds reduce the borrowing cost of local governments, allowing them to provide public services to rural residents and financing to rural businesses at lower cost. Over the years, the use of tax-exempt financing has been increasingly restricted by the Federal Government. The effect of these restrictions and the high fixed costs of packaging and selling small bond issues have combined to make tax-exempt bonds a relatively expensive financing tool for small communities (*4*).

Loan Guarantees

A loan guarantee generally has no budgetary consequence unless the guarantee is exercised, which has made loan guarantee programs increasingly popular as budget pressures have continued. Private lenders make and administer the loans while the Government guarantees repayment. Many of the major Federal direct lending programs were converted to loan guarantee programs during the 1980's. Loan guarantees are now used by FmHA, SBA, the Commodity Credit Corporation, and the Export-Import Bank. The Bush administration has also proposed converting the Rural Electrification Administration's (REA) direct loan program to a loan guarantee program.

Insurance

Insurance programs typically require a fee for the service provided. However, many Federal insurance programs are not actuarially sound, resulting in subsidized insurance. Federal programs were created when private insurers were unable or unwilling to provide necessary coverage for activities that were deemed publicly desirable. Federal insurance programs cover deposits in financial institutions, home mortgages, and flood and crop insurance.

Government-Sponsored Enterprises

Although Government-sponsored enterprises are nominally private, they are Congressionally chartered and typically have a line of credit with the U.S. Treasury. Thus, they are perceived by the financial community as having implicit governmental support. Government-sponsored enterprises were originally established to create financial markets where none previously existed (*17*). These enterprises act as intermediaries to improve the efficiency of markets, most often by providing support for secondary markets. The Federal National Mortgage Association ("Fannie Mae"), the Government National Mortgage Association ("Ginnie Mae"), and the Federal Home Loan Mortgage Corporation ("Freddie Mac") all support secondary markets in home mortgages. The Farm Credit System has the largest rural presence, providing funds for farms, fishing operations, and rural housing. Other Government-sponsored enterprises have not had a large presence in rural areas although the secondary markets for rural home mortgages are becoming more significant.

Revolving Loan Funds

Revolving loan funds (RLF's) are nominally independent from the Federal Government, but have often received a portion of their start-up capital as a Federal loan or grant. They are designed to operate on a continuing basis, reloaning funds earned on their previous loans or investments. Although RLF's do not regularly receive additional Federal funds, the Government still requires those that accept Federal support to operate according to specified standards. Many community development corporations operate in this manner, and the Environmental Protection Agency (EPA) is funding State revolving loan funds to provide money to small communities for sewer and water projects.

The Changing Rationale for Federal Programs

Federal financial assistance programs have historically been based on perceptions of financial market failure, particularly for farms and farm communities. Grants were used to provide assistance when individuals and communities lacked the resources to acquire "essential" goods and services. Credit programs were initially implemented because financial intermediaries were seen as being unwilling to provide adequate amounts of credit in rural areas, either because of high transactions costs associated with making and servicing loans or because of perceived higher levels of risk associated with rural lending.

Over time, the rationale for Federal involvement has shifted toward dissatisfaction with market outcomes rather than imperfections in rural capital markets per se. Nonagricultural rural programs grew in importance as the importance of the agricultural sector declined in rural America. Many Federal programs provide some form of financial assistance to rural residents, but most provide income transfers rather than development funding (*14*). A disproportionate share of economic development assistance appears to flow to urban areas (table 1). Could rural areas take advantage of more development assistance?

In the 1980's, Federal grants for economic development were cut, both for budgetary reasons and because of changing perceptions about the appropriate role of the Government. The "New Federalism," with its greater emphasis on market solutions and return of responsibility to State and local governments, has led to a smaller, more indirect role for Federal programs.

The major direct loan programs serving rural America have also faced changing circumstances. The Farm Credit System was created by the Federal Government in the early part of the century in response to the difficulties

Table 1--Rural share of fiscal year 1985 funding, by agency

Agency	Rural share
	Percent
U.S. Department of Agriculture	49.9
Appalachian Regional Commission	35.4[1]
U.S. Department of Labor	26.1[1]
U.S. Department of Commerce	25.9
U.S. Department of the Interior	25.3[1]
U.S. Department of Transportation	21.1
U.S. Department of Health and Human Services:[2]	
Social security and other entitlement programs	17.2
Health and other programs	10.0
Small Business Administration	16.6
U.S. Department of Justice	15.1
U.S. Department of Education	14.9
Federal Emergency Management Agency	12.9
Environmental Protection Agency	11.0
U.S. Department of Veterans Affairs	10.0
U.S. Department of Housing and Urban Development	4.0
U.S. Department of Energy	1.6

[1] Percentage is based on incomplete information. Complete program data for these agencies were not included in the Consolidated Federal Funds Reports data base.
[2] The U.S. Department of Health and Human Services programs are in two categories because social security and other general entitlement programs differ appreciably from health programs in their rural shares.
Source: (*20*)

farmers faced in obtaining long-term credit at reasonable rates (*5*). The REA, FmHA, and the Rural Telephone Bank (RTB) were also created within the U.S. Department of Agriculture to provide capital to rural areas, initially with a modest degree of subsidy, to allow farmers and small communities to modernize and develop. When these programs were created, agriculture was the dominant activity in rural America. Thus, provisions which helped the agricultural sector also stimulated development of the larger rural economy.

All four programs are clearly targeted to rural areas. At the end of 1988, these programs had outstanding loans of $140.8 billion (*11*). This amount is 10 percent lower than the volume of loans outstanding at the end of 1985 and represents a smaller share of total Federal credit outlays. The declining role of these four programs is not surprising. Agriculture increasingly accounts for a smaller proportion of the economy and, over time, has enjoyed improved access to private sources of credit. The original goals of the REA and RTB, to provide electricity and telephone service to rural areas, have also largely been met.

As the economic base of rural America has changed, so too have financial markets, particularly in the last 10 years. Financial deregulation, starting in 1979, has led to increased competition among financial intermediaries such as banks, savings and loan associations, and other specialized lenders at the national and regional level. But these changes have not benefited all rural borrowers. Some rural banks have been closed in the interest of improved efficiency, while others fell victim to the rural financial crisis of the early 1980's.

The perception remains that inadequate access to capital is a major impediment to economic development in rural areas (*8*). Two distinct issues can be identified. The first concerns adequate access to credit to allow entrepreneurs to begin and expand businesses. The second concern is access by communities to sufficient amounts of capital to improve and maintain essential public infrastructure. Without a solution to both of these problems, rural economies will grow more slowly.

Financial Innovation and Budget Pressures

Financial deregulation has reduced the isolation of rural credit markets. Rural banks previously had access to relatively low-cost deposits, allowing them to provide their borrowers with low-cost loans. Deregulation and increased competition for funds have raised the rates rural banks have to pay to attract deposits and, consequently, the rates they charge on loans. Some lenders have also changed their loan criteria after having been absorbed by larger institutions, reducing their accessibility to traditional borrowers. One effect of deregulation may have been to make traditional sources of capital in rural areas a less reliable and more expensive source of funds for both business and community development (*7*).

Another major change in financial markets has been the creation of new secondary markets, allowing financial institutions to increase their liquidity by selling outstanding financial obligations (*13*). By packaging and underwriting pools of loans, a product is created which can be tailored to meet investors' security, payment structure, and duration requirements.

Finally, the growth of pension fund assets provided a major new source of investment capital. Because they have amassed large amounts of money, pension funds participate in a wide variety of investments. To the extent that rural borrowers can meet the investment requirements of pension plans, these institutions can provide much needed capital for rural development.

These financial market developments, combined with pressures on the Federal budget, have led to major adjustments in Federal programs. Between 1980 and 1988, outlays for economic development purposes fell from $11.3 billion to $5.3 billion. During that period, major direct lending programs were converted into loan guarantee programs. The improved efficiency of capital markets and continuing Federal deficit pressures have led to suggestions for a new round of program changes for the 1990's.

Business Finance

Despite a major expansion in the number and type of financial intermediaries in rural areas, many entrepreneurs still maintain that they are disadvantaged in terms of their access to capital. Two common complaints are the existence of credit rationing and excessive costs of funds (*6*). No strong body of evidence exists to suggest credit rationing or excessive borrowing costs adversely affect rural areas on a systematic basis.

A 1988 survey conducted by the National Federation of Independent Business (NFIB) indicates that both rural and urban members of the NFIB perceive that excessive interest costs are the principal problem with commercial bank loans, not credit availability (*3*). Rates charged rural borrowers were higher than those charged urban borrowers, but rural borrowers required less collateral. The concern with high interest rates, rather than differentials in rates, probably reflects dissatisfaction with U.S. monetary policy rather than credit market inadequacies.

The NFIB results are consistent with Shaffer and Pulver's assessment of the adequacy of rural capital markets (see chapter 3). They found that most rural business owners are satisfied with their local capital providers. Shaffer and Pulver found no evidence of a widespread capital adequacy problem, nor could they identify types or stages of business which always had difficulty acquiring capital. However, their research indicated that particular types, sizes, and stages of businesses have difficulty acquiring sufficient capital in some rural areas. New firms, expanding firms, firms in new industries--all important for rural economic development--have difficulty in certain markets, largely because of inadequate information about sources of funds and the risks posed by lending to these types of firms. However, no study of rural business' access to capital has included businesses that did not start because of the lack of affordably priced capital, and no satisfactory procedure has been developed to validate a lender's decision to refuse funding.

Financing Infrastructure

Financial assistance for infrastructure has historically been one of the Federal Government's major rural development activities. Funds from Government institutions, such as the REA and FmHA, have been used to finance the construction and maintenance of basic infrastructure in rural areas. Funding has typically been available to local governments and nonprofit organizations, such as local cooperatives or communities. Some investor-owned utilities have also received funds. However, during the 1980's, funding levels declined as infrastructure requirements increased (*16*).

Federal assistance has generally been at subsidized rates, although the magnitude of the subsidy has varied over time. This situation reflects the importance of infrastructure to the Nation and its relatively high cost in small and remote communities. Higher infrastructure costs are offset, to some degree, by lower interest rates on direct loans from the Federal Government. Still, rural residents typically have to pay higher unit costs for basic services than urban residents, even with subsidized credit programs.

Increasingly stringent Federal environmental quality and safety standards are placing a major burden on small communities (see chapter 4). Because they reflect broad-based safety and environmental quality concerns, these standards are independent of a community's ability to afford them. However, many small communities, particularly in rural areas, cannot afford to comply with these requirements. This problem provides a rationale for continued Federal assistance, but on public health or equity grounds and not necessarily for economic development purposes.

In many rural areas, the long-term stagnation of local economies in the 1980's and reduced Federal assistance have resulted in inadequate maintenance and upgrading of infrastructure (*15*). For these communities, inadequate infrastructure may now impede economic growth. In the absence of financial support, these shortfalls will probably not disappear. This is not to suggest that adequate infrastructure is sufficient to stimulate growth. Rather, additional investment in infrastructure is often necessary before growth can occur.

When communities more directly controlled the services they provided, a case could be made for letting each community finance its own infrastructure. However, local communities are increasingly required to provide a certain level and mix of public services by Federal and State mandates, judicial rulings, and other regulations. As a result of the public good nature of infrastructure, there is a stronger case for Federal and State assistance in financing infrastructure, particularly when it serves needs beyond those of the local community.

Current Programs

Because of the growing importance of small businesses as sources of employment nationally and in rural areas, ensuring these firms adequate access to credit should be a major public policy concern. FmHA finances rural businesses through its business and industry loan program, but the SBA is the main Federal agency assisting small businesses. Both agencies provide loan guarantees and participate in relending activities. For example, SBA's Small Business Investment Corporation (SBIC) program provides low-cost funds to qualifying financial intermediaries specializing in small business finance. The U.S. Department of Commerce has a similar matching-fund program, EDA's revolving loan fund program, and FmHA operates a small intermediary relending program. Loan guarantees are available from FmHA, SBA, and the National Oceanic and Atmospheric Administration (for fish processing facilities) (*19*).

Fractional loan guarantees have definite advantages from a Governmental accounting perspective because they do not count as budget outlays unless the loan is in default. Although the underlying quality of the loan, and hence the ultimate loss, may not differ, deferred outlays are always preferred to current outlays. A fractional guarantee should encourage commercial lenders to make loans that they might otherwise be reluctant to make, because the Federal Government absorbs a significant portion of the default risk.

The guaranteed portion of the loan can also be sold into a secondary market, allowing the lender to recover the bulk of the funds advanced in the loan. This arrangement increases lender liquidity and can lead to greater lending. Loan guarantees should increase credit availability in rural areas and reduce the cost of borrowing because they reduce lender's risk. However, because the lender still must absorb the initial loss on the unguaranteed portion of the loan, there is a strong incentive for the lender to apply prudent credit standards. Thus, loan guarantee programs may stimulate additional lending in tight credit markets but may not have much effect when lenders have a surplus of loanable funds, because inadequate demand is the underlying problem (*6*).

The Federal Government also has other means of stimulating credit availability in rural areas. Rural Electric Cooperatives recently received authority to lend money for business development purposes. Similarly, the Farm Credit System can finance cooperatively owned farm-related businesses. Both the Appalachian Regional Commission and the Tennessee Valley Authority provide a limited amount of business development funding (*19*). The Federal Government also affects the availability of capital from private lenders by providing certain types of lenders with tax concessions and seed capital. For example, Community Development Corporations (CDC's) operating revolving loan funds were established in the 1960's and 1970's with Federal financial assistance and continue to invest in small business (*2*). Most CDC's are in cities, but some operate in rural areas, particularly in the Northeast.

The Changing Federal Role and New Initiatives

The minimum Federal role in rural finance is to ensure that capital markets are efficient. Many rural areas have historically suffered from limited competition, with few commercial banks providing the only source of funds. Markley's research suggests that banks in a rural community may have fairly similar lending criteria and rates (*9*). By itself, this observation tells us little. Such a situation is consistent either with a very competitive market or with a very oligopolistic market. Lenders may either be meeting the competition or implicitly avoiding competition. We only have limited information on the performance of specific rural financial markets.

Budget constraints and the inability of the Federal Government to credibly assess the probable performance of a small business make major direct lending programs difficult to justify. Because of the profit orientation of business, arguing for direct government assistance for one firm that is in direct competition with other nonassisted firms is also difficult. The Federal Government can, however, play an important role in enhancing the performance of markets by improving business information, increasing liquidity, and spreading risk in rural markets. All of these actions should increase the volume of loanable funds and lower borrowing costs. These are the same types of activities the Government has successfully used to improve the market for home mortgages.

Improving information includes providing potential borrowers with the means to make better business plans and lenders with more information to assess the risk potential of nontraditional loan requests. Risk spreading activities relieve lenders of having to absorb all the risk associated with their portfolios. Small lenders serving a geographically limited market may be unable to commit funds to business loans because the performance of their entire loan portfolio faces highly correlated risk. Because many rural lenders lack geographic diversity, all their loans are subject to event risk (for example, a natural disaster or a labor strike against a major employer) which affects the health of the local economy.

A small bank may similarly lack the capital to make additional business loans, particularly if it has just absorbed significant loan losses or if the loss potential of lending for nontraditional purposes is unknown. Loan guarantees are one way of spreading risk, and may be particularly appropriate if the Government believes that less capital is being made available than is socially optimal. As banks and bank markets increase in size, they are also better able to absorb risk internally. Banks with a larger service area are less subject to the vagaries of a local economy and are more likely to be able to absorb losses associated with local economic downturns.

Increasing liquidity provides relatively small local capital markets with the opportunity to recycle funds and improves the flow of funds from savers to borrowers nationally. If local banks can sell a portion of their loans, they can make more loans. Thus, lenders with local knowledge may be able to make additional sound business loans, and investors may be able to purchase loan-backed securities tailored to meet their particular investment needs.

Pooling loans also reduces credit risk by spreading losses among a large number of investors, rather than leaving losses concentrated among individual lenders. The probability of any given loan defaulting does not change, but the effect of a default is less traumatic. Under pooling systems, lenders face small losses with certainty rather than the possibility of a catastrophic loss.

The Bush administration, Congress, and various interest groups have identified several programs as alternatives to existing financial assistance activities. Most of the proposals receiving serious consideration have the Federal Government playing an indirect role, thereby holding down immediate outlays.

Housing Vouchers

For several years, the administration has proposed replacing the existing FmHA direct lending program for rural housing with a voucher system that would provide low income residents with rent supplements. The U.S. Department of Housing and Urban Development operates a similar program in urban areas. Instead of directly financing the construction of low- and moderate-income housing and having to deal with the repayment process, a voucher program encourages private developers to provide sufficient low-income housing by increasing the returns on rental units.

Vouchers are essentially grants, but their use eliminates the budgetary problems of direct loans and the potential loss from borrower defaults. However, rent vouchers are unlikely to promote home ownership, and whether vouchers will result in adequate rental housing is unclear.

Enterprise Zones

Rural enterprise zones have been suggested as a new way to foster business development in rural areas. An enterprise zone relies on tax concessions and other publicly provided benefits to businesses that agree to locate within designated areas. Several bills have been introduced in Congress to create these zones, and a number of States have implemented enterprise zones. The limited evidence to date suggests the difficulty of targeting benefits to firms that would not have located in the zone anyway, and that fairly significant benefits are required to make many zones attractive.

Larger businesses with existing tax obligations are more likely to be attracted by an enterprise zone than are smaller, new firms. Rural zones, therefore, could be attractive to branch plants. Yet, small businesses are most likely to find rural locales suitable, which raises questions about the effectiveness of enterprise zones as a rural development approach.

REA Loan Guarantees

The REA can now borrow from the U.S. Treasury to make direct loans to rural power and telephone cooperatives, but the administration has proposed using fractional loan guarantees as a means of financing these and other rural investments. Private lenders would supply the funds at market rates, with the Federal Government avoiding any budget outlays unless these loans go into default.

One immediate consequence would be reduced Federal borrowing and a drop in the deficit, because most REA lending is at subsidized interest rates. However, higher interest costs for rural electric and telephone cooperatives may increase the cost of their activities to a point where they are not financially viable.

Rural Capital Access Program

Current legislation in the Senate (S.1036) contains provisions to improve rural credit markets by creating a loan loss reserve fund. Lenders, borrowers, and the Federal Government would each contribute to a reserve fund. The reserve would act as a form of insurance for lenders, providing them with a guarantee on qualified loans.

Proponents of the plan argue that lenders will be more willing to make business loans in rural areas with this form of protection. However, borrowers may face higher loan costs as a result of having to pay into the reserve, which may limit their desire to participate in the program.

Rural Small Business Investment Corporations

SBIC's play a very limited role in rural America. These corporations are designed to supplement traditional lenders and equity providers by providing a mix of debt and equity finance to small businesses. The small business committees of Congress have recently considered changes in the legislation governing SBIC's to make the program more like a Government-sponsored enterprise (rather than a direct lending and guarantee program). During this process, a special class of SBIC's might be created to operate in rural areas. Legislation could facilitate the creation of rural SBIC's by giving them a favorable access to funds, setting a smaller minimum SBIC size, and encouraging joint ventures.

Small Community Infrastructure Fund

Two of the major problems facing small communities are the difficulty lenders have assessing the financial status of small governments and the higher premiums investors require for small-volume, illiquid bond issues. A study for the National Council on Public Works Improvement proposed the creation of a national infrastructure finance system to deal with these problems (*1*). By acting as an intermediary and either directly pooling bonds or selling its own bonds to raise funds, a Federally sponsored infrastructure fund could reduce financing costs for small, rural communities. From the Federal perspective, the fund could improve infrastructure in rural areas without imposing the direct budget outlay associated with direct loans. Such a fund might also result in lower contingent liability than is associated with guaranteed loans where the Federal Government is directly responsible for each guarantee. The creation of an intermediary that can pool risk and assume the initial responsibility for defaults reduces the likelihood that the Federal Government would be liable for the losses on any given loan.

Rural Partnership Fund

Proposed legislation in the Senate contains a provision to set up new revolving loan funds which would be jointly financed by the Federal Government and private or State and local money. The loan funds would be similar to existing community development corporations by taking a subordinated debt or equity position in rural businesses.

By placing their funds at the greatest risk, the partnership fund might induce banks to provide the bulk of the financing needed by rural businesses. The legislation also proposes that the partnership fund help businesses develop sound plans, both to protect the fund's investment and to encourage participation by other lenders. The premise of the partnership fund is that a modest amount of subordinated debt provided by the fund will induce other lenders to participate in financing rural businesses.

Conclusion

The perception remains that inadequate access to capital is a major hurdle for rural development. Changing economic conditions and financial markets have reduced the significance of existing programs, but Federal assistance is still needed. In aggregate, it is hard to make a case for either widespread credit market failure or inequitable access to credit. Yet there appear to be instances where inadequate access to capital has limited rural economic development.

The Federal Government's role should take into account the needs of rural areas, the limited abilities of the Government, and the structure of financial markets. A more targeted approach is necessary to focus Government activity where problems exist. In the case of business credit, the primary role of the Federal Government should be to assure that markets are fair and competitive. For rural infrastructure finance, the public-good nature of this function admits a larger role, but even here there is no case for blanket assistance.

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