

**The Adequacy of Rural Capital Markets:  
Public Purpose and Policy Options**

**U. S. Senate Committee on Agriculture, Nutrition and Forestry  
Hearings on Capital Markets in Rural America  
328A Russell Senate Office Building  
Washington D.C.**

**Written Testimony of  
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September 4, 1997**

**Economics Staff Paper 292**

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Abstract: This testimony highlights the author's observations regarding gaps in rural financial markets as they relate to rural develop and legislative opportunities for addressing the gaps identified. The observations are based on the author's experiences and literature reviewed as a member of two national expert panels organized by the Rural Policy Research Institute to provide policy makers and staff with analysis on (1) alternative proposals for the rural development title of the 1996 farm bill and (2) the adequacy of rural financial markets in support of rural development.

KEY WORDS: Financial markets, capital markets, rural finance, rural capital, risk capital, equity capital, venture capital, debt capital, farm credit system, banks, Farmer Mac, Federal Home Loan Bank, rural finance policy.

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**IOWA STATE IS AN EQUAL OPPORTUNITY EMPLOYER.**

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Mr. Chairman and Committee Members, I appreciate the opportunity to testify before the Senate Committee on Agriculture, Nutrition and Forestry regarding rural capital issues. Several perspectives inform my comments today. I am an Extension public policy economist at Iowa State University. I serve as a member of the Rural Policy Research Institute's (RUPRI) Rural Finance Task Force. Many of my comments are grounded in the RUPRI Task Force background white paper "The Adequacy of Rural Financial Markets." cited as one of the four studies for review and discussion at today's hearing. At the request of the ISU Vice Provost for Extension, I am leading a dialogue with a diverse group of sparkplug rural community economic development and financial leaders on innovative rural capital projects in western Iowa. I am also a partner in a rural community housing development project. Finally, I have served as a city council member for Boone, Iowa population 12,500--a city that is wrestling with issues of economic development, infrastructure and housing from a rural community perspective.

The guiding concern of the RUPRI panel's white paper is: "What is best for Rural America?" It is the RUPRI panel's presumption that the national policy goal is to help create an environment in which rural people can fully participate in the economic opportunities available in the wider economy.

USDA-ERS data show the historic farm income problem faced by our nation for most of the twentieth century has been solved on average. Over the decades, per capita farm income has risen from 30 percent of national per capita income during the 1920s and 1930s to over 100 percent in the 1970s. It fell to about 80 percent in the 1980s, but it has hovered around 100 percent since 1990.

In 1995, the household income including off farm income for small and mid-sized farm operators (gross sales less than \$250,000) averaged about 90 to 100 percent of the national average household income. However, the next 70,000 farm operators with gross sales between \$250,000 and \$500,000 have average household incomes of \$72,518 or 171 percent of the national average. The 43,000 largest farms with gross sales over \$500,000 have household incomes of over \$155,000 or 364 percent of the national average household income.

In regards to provision of credit, the large farms represent the growth segment of agriculture. This market segment is characterized as a relatively small segment in terms of farm numbers, but it represents an increasingly competitive financing environment for capital suppliers. ERS data show the larger farms rely more on equity and use a lower level of their debt capacity than smaller farms. The number of mega farms is expected to increase as agricultural industrialization and integration trends continue. The two largest farm segments combined account only 6 percent of the nation's farms, but over half of the nation's agricultural production. One concludes that agricultural policy solutions based on volume of production will increasingly fail to impact rural America or to impact a majority of America's farmers to the degree that they once did.

While the historic farm income problem has been solved on average, the rural income problem remains. The differential between average household incomes in nonmetro America remains about 75 percent of the average household income for metro America.

We used to say if it was good for agriculture, it is good for rural America. But in 1995, about three-fourths of U.S. farm operator households have small farms with gross sales of less than \$50,000. These households depend mainly on off-farm sources of income because their farm enterprises lose money on average. Off farm sources of income represents about two-thirds of the household income for farm operators with \$50,000 to \$250,000 in gross sales. For farmers with \$250,000 to \$500,000 in gross sales, about 40 percent comes from off farm sources. For the farms with gross sales over \$500,000, about 20 percent comes from off farm sources. So on average, all farm size categories--even mega farms--depend on the off farm economy as a major sources of income.

The rural economy is now more broadly based than agriculture. The farm population represents less than 2 percent of the national population and continues to decline. In terms of national importance, the Census definition of nonmetro rural population represents 21 percent of the nation's total population but it might be as high as 33 percent if the rural areas of metro counties are included in the rural definition. Since 1990, nonmetro county population growth has risen 5.9 percent, which is one percent lower than metro population growth. Most rural population growth is coming from metro migration while most metro population growth is coming from births minus deaths and immigration.

Agriculture is still important to rural America, particularly in the roughly 10 percent of the nonmetro counties that ERS considers agriculture-dependent. Most of these counties are located in the Midwest and Great Plains. This area faces some unique challenges and continues to experience declining population in about half of its nonmetro counties during the 1990s. But bright economic spots can be found even in many of these declining counties. It is not uncommon in Iowa to find economic and population growth in rural county seat towns, but this growth is being offset by the declines in the farm population. Some research increasingly suggests that many Americans prefer a rural lifestyle, provided that acceptable income, employment and housing opportunities are present. Today in Iowa, the non-farm rural population living in the country outside of city limits is greater than the farm population.

However even in Iowa's agriculturally-dependent nonmetro counties, manufacturing, retail trade, services and government exceed agriculture's 9 percent share of personal income for the nonmetro counties. As a result, significant progress toward reducing the nonmetro-metro income differential is not likely to be met by exclusive reliance on production agriculture solutions. Farm and nonfarm rural community leaders need to work together in a balanced approach to work on both the farm and nonfarm economic base in rural America.

## What are the Capital Market Gaps?

Financial markets allocate capital to facilitate economic progress, but gaps in financial markets and barriers to access can make it difficult or impossible for some individuals and communities to adapt to change or to make the transition to new economic activities that might otherwise increase income, employment and quality of life in their rural community. The RUPRI Rural Finance Panel white paper includes responses to seven key policy questions regarding potential gaps in the adequacy of rural financial markets. The Panel's responses were developed following a review of existing research findings and a series of listening sessions conducted with representatives of a wide range of private sector interests and public agencies. The following is a summary of panel findings:

1. Some industry experts predict that 60 banks will account for 80 percent of the bank assets nationally in the next five years. Accelerated bank mergers can create transitional and/or permanent changes in rural capital markets. Evidence shows that in rural communities where a local bank is merged with a large holding company or becomes a branch of a large and distant bank, there often is a reduction in lending to local businesses or changes in newly merged bank's business focus.

2. Financial market regulations often impose somewhat greater costs on smaller lenders that are characteristic of most rural communities. Safety and soundness regulations often limit the size of loans to individual borrowers and can constrain a lender's ability to fund large projects. Regulations also encourage standardization of credit decisions, which may constrain the ability of rural lenders to serve opportunities which do not meet standardized criteria. Finally, increased complexity of regulations allow larger institutions to spread specialized management staff over a larger volume of accounts, while compliance efforts stretch scarce management resources in smaller banks that often have a thin layer of management.

3. Most rural borrowers with relatively routine credit needs are well served by existing lenders. However, borrowers with large debt capital needs, small business start-ups, and business opportunities unfamiliar to their lenders can expect more difficulties in obtaining credit

4. Equity capital markets, other than informal activities of individual investors, are unorganized and virtually non-existent in rural communities. The absence of organized rural equity capital funds, business angel networks, and technology-oriented business incubator and entrepreneur development networks in most rural communities arguably both slows the growth of existing rural businesses and prevents the start up of otherwise promising businesses.

5. Rural communities often have more difficulty in financing infrastructure projects, particularly smaller rural communities. State and federal standards for infrastructure are often designed for larger urban places. In addition, smaller rural communities have limited taxing and repayment capacity. Large infrastructure projects often have the effect of raising costs disproportionately for small rural communities, simply because there are fewer people over which costs can be spread.

6. Financing housing construction and ownership is often more difficult in rural communities. Few building sites, cost of infrastructure development, and lack of housing market liquidity can often provide risks perceived to be insurmountable for private developers. Most existing state and federal housing programs are targeted to low income groups and senior housing, which can lead to gaps in middle-income housing. A shortage of rental and middle income housing can frequently limit economic development recruiting and retention efforts.

7. Intergenerational transfer of assets presents an opportunity as well as a chronic threat regarding the ability of financial intermediaries to regenerate investment and debt capacity for many rural communities.

### **Will Various Policy Initiatives Fill the Gaps?**

Using the RUPRI Panel's white paper and continuing dialogue as a basis for discussion and analysis, I have developed the following observations regarding various policy alternatives under consideration and discussion.

**Option 1. Farmer Mac Secondary Market for Rural Development Loans.** Creation of an effective secondary market for rural development loans that meet the USDA "business and industry loan" criteria would accomplish three things in regard to the gaps identified by the RUPRI panel. First, it would allow community lenders to more effectively serve large projects and projects requiring longer term financing that might not otherwise be served. Second, it would allow smaller community lenders an opportunity to transfer interest rate and local project risks to an external pool that appropriately spreads the risks over a larger portfolio of projects and a market willing to accept such risks. Thus a unique local business and industry development project is served in a method that does not jeopardize the safety and soundness of the rural community lender. Finally, a wide range of lenders including community banks, the Farm Credit System affiliates and other institutions could potentially utilize an effective secondary market in business and industry loans to the degree that charters permit.

**Option 2. Broader Federal Home Loan Bank (FHLB) Charter.** Including "small" business and industry loans, agricultural loans, and possibly infrastructure under "rural development" loan authority for the FHLB system would allow community lenders to pool and access GSE participation to transfer some risk and to tap the interest rate yield curve at any maturity to better match the term of loans more appropriately with project life. Presently, many community lenders have limited ability in providing longer term loans for agriculture and rural development, particularly for small business start ups, non traditional business enterprises and large projects. This FHLB proposal would address each of these gaps except large projects.

**Option 3. Broader Farm Credit System (FCS) Charter.** FCS flexibility in facilitating rural development could be enhanced if limits were removed and authority broadened for nonagricultural business and industry loans, housing, infrastructure and equity capital participation. Presently, FCS affiliates are barred from equity participation beyond FCS affiliates. Housing is constrained to housing for farmers, cooperatives and smaller rural communities. Business loans are primarily for businesses owned by farmers and cooperatives. And, infrastructure is limited to small rural communities. Portfolio diversification and participation could reduce the risks faced by FCS during major agricultural downturns. While FCS has authority for an internal equity capital foundation, external equity capital participations with local and regional community development corporations and SBICs are not allowed.

**Option 4. A Combination of Options.** In contrast to conventional wisdom, the first three options are not mutually exclusive from a rural community perspective. In fact they are complementary and more capital market gaps would likely be reduced if all three were considered as a part of the same package. Rural communities are diverse in their resources, leadership capacity and circumstances. The financial market gaps and policy interventions that work in one rural community often do not work for a neighboring community due to lack of community leadership, community capacity, or lack of interest on the part of a key local financial institution. Therefore, policy approaches which empower a broad range of institutions to address the identified gaps in rural financial markets are more likely to significantly enhance the adequacy of rural

capital markets in serving rural America compared to approaches which favor expanding the charters of a single class or type of institution. If a narrow approach is used, some communities and rural institutions will receive opportunities for competitive advancement, however the gaps faced by other rural communities potentially served by other financial institutions will remain unaddressed.

**Option 5. Facilitating Rural Equity Capital Markets.** Nationally, about \$4 billion is invested annually by organized venture capital funds. It is interesting to note that about \$10 billion is invested annually by informal business angel networks. Business angels are defined in the venture capital industry as high net worth individuals who invest in and provide external guidance to startup companies. According to some experts, there is a need for \$60 billion annually to support new startup companies. While this seems like a large amount, it is dwarfed by the amounts annually invested in the national stock markets. Organized venture capital funds and networks of business angels are non-existent in rural America. However, access to equity capital is critical for entrepreneurs and small business startups, particularly those based on capital intensive technology.

Potential business angels and significant equity capital exist in rural America. More than half of Iowa's farmland is owned debt-free. Certainly due diligence is required to evaluate the business opportunities before any investor considers investing in new startup companies. But if done right, due diligence could be enhanced by better organizing local/regional equity capital markets. The alternative may be to write off much of the potential for rural America. In the future, jobs will go where capital investment goes. The rural challenge requires two building blocks: (1) organizing networks of rural community business incubators and entrepreneur development programs to generate viable business projects, and (2) organizing rural equity capital networks, rural venture funds and/or regional networks of community foundations that can appropriately spread risks and evaluate viable entrepreneurial projects in ways that provide due diligence so rural landowners and main street professionals can invest with reasonable risks.

The RUPRI Panel clearly identified organization of rural equity capital markets as an area where more information is needed to inform public policy decisions at all levels. The Alternative Agricultural Research and Commercialization Corporation included in the 1996 FAIR Act is a unique model of federal leadership in this area matching equity capital with promising entrepreneurial ventures, but it represents a relatively small effort when viewed from a national scope. The AARCC model and/or other models which may exist could appropriately be evaluated and adapted on a local/regional basis throughout rural America to begin to address this capital market gap.

**Option 6. Create Improved Access and Flexibility for Rural Housing.** Rural Economic developers lament that they cannot attract jobs without housing and they cannot build housing without jobs. Most state and federal housing programs target assistance to Low and Moderate Income (LMI) standards, which often misses many rural middle-income family housing needs. Removing the (LMI) restrictions on some federal housing programs and elimination of the rural differential in programs where LMI standards are retained would contribute to solving this uniquely rural housing problem. If LMI restrictions and rural differentials are removed for some programs, existing programs become more flexible in addressing a wider range of needs for communities that often lack capacity to access grants..

Many rural communities lack of buildable lots. Specifically targeting some housing assistance programs to address the lack of entrepreneurial developers, infrastructure costs and availability of buildable lots for middle income populations would help address this issue. In one recent anecdote, a beginning housing developer and banker spent two months trying to determine whether any programs were available to

assist a startup rural community housing project for the middle income market. There wasn't any assistance other than local government incentives.

Another approach would be to require government sponsored enterprises (GSEs) with public purpose charters in housing-- such as Fannie Mae, Freddie Mac, and Federal Home Loan Bank-- to target a greater portion of their revenues to underwrite the liquidity of housing markets and viable housing developments in nonmetro counties with realistic growth potential. Recent experience suggests that action by some GSE's does not match the rhetoric.

Finally, block granting a portion of the housing funds to rural communities or groups of rural communities with more than 50,000 population would increase capacity and flexibility for rural communities to address their unique mix of local low income, middle income, senior, and/or housing infrastructure needs. Many rural communities still lack the professional capacity to jump through the hoops of the existing housing programs which may or may not fit local needs. At the same time, metro-areas with over 50,000 in population continue to receive entitlement funds for their local housing efforts.

**Option 7. Infrastructure Flexibility and Regional Planning.** Regional approaches to infrastructure planning can allow smaller communities to pool their resources with other communities to utilize economies of scale in infrastructure projects and shared repayment capacity. Community size restrictions for infrastructure assistance programs sometimes create barriers or reduce incentives for larger rural communities to work with smaller neighbors. In addition, the RUPRI white paper suggests focusing rural community infrastructure regulations on quality standards--not best technology standards. Best available technologies are sometimes not scale appropriate for smaller communities.

**Option 8. Technical Assistance to Empower Rural Capital Markets.**

A number of existing authorities and policy tools are presently available but are underutilized. For example I am presently working with a group headquartered out of Manning, Iowa population 1,500 that includes six rural banks from neighboring communities, a rural utility, farm group and a university technology business incubator that is interested in examining the federal Small Business Investment Company (SBIC) authority to create a regional venture capital fund and network of rural community business incubators and entrepreneur development programs. SBICs are chartered through the Small Business Administration and allow banks to invest up to 5 percent of their capital in these entities for purposes of providing a wider range of debt and equity financing tools for assisting startup businesses. But it was interesting when I called SBA, I discovered that it is mostly large banks that are utilizing the program. With a 5 percent equity limit, it takes a larger number of small banks to reach the \$20 million venture fund industry threshold. In addition, small banks and communities often lack the discretionary resources and technical expertise to know whether such models are appropriate. They are unfamiliar with the potential payoffs. A variety of private interest groups, foundations and public agencies could have something to contribute to an initiative for overcoming these barriers.

**Rural Finance Reform Principles and Policy Checklist.**

In 1995, another RUPRI rural policy panel with 13 different national experts and practitioners was preparing backgrounders for the 1996 Farm Bill debate. This panel developed a checklist of principles to assist in judging the rural development implications of rural finance policy reform. The work of this previous panel supports the more recent RUPRI analysis, in that the checklist of questions developed appears to be as relevant today as it was then:

## **Does the finance reform....**

- 1. Strengthen Market Driven Debt and Equity Capital Markets** so rural America can fully utilize it's resources, income generating capacity and economic contribution to the overall economy.
- 2. Strengthen Community Access to Appropriate Financing Expertise** for each significant opportunity for rural community development.
- 3. Provide Community Access to Wholesale Debt Capital Markets** and intermediation necessary for sustainable rural development.
- 4. Provide Community Access to Equity Capital** necessary for sustainable rural development.
- 5. Encourage Coordination, Partnering and Integration of Sources of Rural Capital** to match risk bearing capacity, responsibility and reward with appropriate size and diversification of rural portfolios.
- 6. Facilitate Appropriate Levels of Intergenerational Transfer** of business assets necessary for stable investment and rural community economic growth.
- 7. Increase Ease of Identification and Access to Assistance Programs** by local government and private sector development groups.
- 8. Provide for Rural Community Representation** in addressing finance and capital needs of rural communities.

In closing, a 1995 RUPRI Poll conducted by the Gallup Organization suggests that urban as well as rural citizens are widely supportive of various rural finance reform strategies to improve the development opportunities in rural America. With an accuracy of +/- 4.3 percent, strategies receiving endorsement from more than two-thirds of the weighted sample of rural and urban respondents included (1) assistance to startup businesses for young entrepreneurs, (2) rural development loan guarantees, (3) reform to allow rural lenders to organize multi-community funds that invest in new and expanding industries in rural areas, (4) reforms to provide rural lenders with increased access national money markets for financing larger rural economic development projects, and (5) managerial, marketing, and financial technical assistance targeted to young entrepreneurs.

While public attitudes may have changed a little, the support underpinning this wide range of strategies suggests that a more comprehensive set of reforms might potentially receive broad public support if an important public purpose can be articulated. A final point worthy of note is that most of the strategies outlined can be accomplished within the bounds of existing appropriations by increasing flexibility and articulating a greater sense of direction for existing institutions. Not all institutions will take up the challenge. Not all rural communities will take up the challenge, nor do they all possess the same opportunities and outlook. But never underestimate the resolve of many rural community leaders. Early adopter communities are moving forward in their transitions to a new information age and global economy. Others are close behind the early adopters. If given more flexibility combined with alternatives for closing some of the existing gaps in rural capital markets, the rural income differential can be reduced and the potential of rural American contribution to the national economy and quality of life will be greatly enhanced.



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