The State As "Public Entrepreneur":

Public Chartering of Privately Financed Development Institutions

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EXECUTIVE SUMMARY

Small businesses create jobs, are an important source of technological innovation, and provide returns on investment that are commensurate with the profit levels of much larger firms. State development planners, therefore, have important reasons for promoting the expansion of small businesses. The imperfect operations of capital markets, however, make it difficult for small firms to find long-term debt or to issue equity in public capital markets. One way for states to intervene to rectify capital market failures is to use state regulatory powers to establish publicly chartered but privately financed and managed development finance institutions charged with providing capital to small firms.

Capital markets fail to operate efficiently whenever capital is not allocated to ventures on the basis of the expected rate of return adjusted for risk. Institutional lenders and individual investors tend to be risk-averse and choose not to finance businesses whose riskiness goes beyond certain narrowly defined limits. Small firms tend to be risky investments since the failure rate for small businesses is high and lenders have difficulty predicting which ventures will succeed and which will fail. Rather than raise the required interest rate on riskier small business investments and loans, potential investors refuse to
consider such loans at any cost. Other capital market imperfections—such as high information and transaction costs involved in arranging an investment, statistical discrimination, and government regulation—reinforce investor hesitancy to finance small businesses.

States have three strategies to choose from when they wish to promote economic development: imposing regulations, offering economic incentives, and direct intervention. Regulation aims at controlling the behavior of financial institutions such as commercial banks and savings and loan associations by imposing restrictions on the use of funds by or the flow of capital to those institutions. Incentives such as interest subsidies or credit insurance can be used to encourage investment in socially desirable directions. Direct intervention involves the creation of publicly sponsored development finance institutions. Regulation is the least risky and least expensive alternative available to state planners. Direct intervention is the most risky and most expensive. This paper focuses on the use of regulation to promote economic development.

Positive, active regulation can capitalize on state chartering powers to establish publicly sponsored but privately capitalized and managed institutions to achieve designated public policy objectives. The goal is to harness the profit motive, efficiency, and resources of the private
The State As "Public Entrepreneur"

The state uses its chartering and regulatory powers in a creative way, acting as a "public entrepreneur" to promote private sector investment in small businesses.

Four well-developed models exist that demonstrate the usefulness of the "public entrepreneurship" approach: New LIFE, the Massachusetts Lending Corporation, Maine Capital Corporation, and the Massachusetts Capital Resource Company. None of the models requires direct appropriations from the state (some require tax expenditures) and none involves the state in a managerial capacity.

New LIFE (Low Interest for Expansion) is a consortium of 22 savings banks in western Massachusetts organized to provide industrial mortgages to mature firms unable to obtain financing from conventional lenders at reasonable rates. Members reserve 1% of total deposits for New LIFE loans. New LIFE member banks capitalize on their close ties to the local business community and evaluate loan applications in terms of the potential for preserving or creating jobs. New LIFE operations are founded on the participation principle, so that the consortium can pool and spread lending risks that would overwhelm any one bank. It is a decentralized organization, but the common tie is the expectation that New LIFE loans will increase the sector to accomplish publicly desirable ends by providing sufficient regulatory incentives and sanctions. In short, the state uses its chartering and regulatory powers in a creative way, acting as a "public entrepreneur" to promote private sector investment in small businesses.
deposit bases of its members as more jobs are created within the New LIFE service area.

The Massachusetts Lending Corporation (proposed) represents an extension of the New LIFE framework to the state level. It is an example of the supportive role that state regulators can play by sponsoring publicly chartered but privately financed and managed development institutions. Mass Lending would operate as a privately owned central lending facility, funded by stock purchases by participating banks. The Corporation would package loans from around the state and call upon member banks to provide lines of credit based on pro-rated shares of stock ownership. Mass Lending would also raise long-term debt to supplement its equity capitalization and increase its lending capacity. The state charters the corporation but does not fund its operations or put its full faith and credit at risk.

The Maine Capital Corporation is a publicly chartered venture capital company capitalized by private investors who take advantage of state tax credits for investing in Maine Capital. The Corporation fills a gap in the Maine capital market by providing equity financing to small firms in Maine who produce for export to the rest of the country. The Corporation supplements its equity financing with long-term debt. It is privately managed and uses
traditional return requirements to analyze investment possibilities. The state places no restrictions on the kinds of investments it can make and emphasizes before-the-fact incentives, rather than post-facto sanctions, to induce private sector players to commit their resources for publicly desired objectives.

The Massachusetts Capital Resources Corporation (MCRC) represents the largest and most successful example of the "public entrepreneur" concept. It is a privately managed debt equity/institution capitalized with $100 million provided by eight life insurance companies in return for state restructuring and reduction of taxes on the insurance industry. The state defined clearly designated categories of permissible investments in small firms, reserving the right to readjust taxes should MCRC fail to reach proscribed levels of small business lending within a specified schedule. Mass Capital has been very successful in providing capital to small firms traditionally locked out of private capital markets and illustrates the effectiveness of harnessing private sector resources by providing strong regulatory incentives and sanctions.

State economic development programs often lack the financial resources and managerial capabilities required to redirect large amounts of capital to the small business sector. In order to maximize the effectiveness of limited
state resources, development planners can use regulatory powers in an active, positive, and creative way to induce private sector institutions, investors, and managers to pursue desirable public objectives—while seeking financial profits. Regulation is a relatively riskless and inexpensive form of intervention. Each of the models analyzed in this paper is capable of being replicated in other areas for similar purposes, depending either on the strength of specific financial sectors or on the ability of the state to offer sufficient "carrot and stick" incentives.
INTRODUCTION

State-sponsored economic development programs have traditionally directed tax and cost-of-capital incentives to larger firms, hoping to influence plant location and expansion decisions in the belief that large businesses were the real source of net job creation and increases in tax revenues. Recent studies evaluating the contribution of small businesses to the U.S. economy have demonstrated the limitations of this strategy, however. These studies make three basic points. First, more than half of all jobs created derive from the expansion of existing small firms. Second, small firms as a class are at least as profitable as their larger and older counterparts. Third, these same small businesses are a major source of technical innovation, a characteristic with important ramifications for economic development since innovation usually produces rapid expansion and increased productivity. In short, smaller businesses provide tangible benefits in terms of employment, tax revenues, and innovation that makes their sponsorship an essential part of any state level economic development plan.

An important problem associated with encouraging small business development stems from the imperfect operations of private capital markets. For a number of reasons, to be more fully explored in this paper, small businesses
find it difficult to arrange long-term debt or to issue equity in public capital markets. The lack of expansion capital available to small, rapidly growing, profitable enterprises severely limits the degree to which such firms can continue to create new jobs, provide increased tax revenues, or innovate. It is a problem of real concern to planners, public sector administrators, small business managers and entrepreneurs. This paper, together with its companion paper, form a two-part analysis of the capital availability problem as it affects small businesses.

This paper will examine the capital-market-perfecting roles of various state-level publicly chartered but privately financed and managed institutions charged with providing capital to small- and medium-sized businesses. It will briefly lay out the importance of smaller enterprises to a successful economic development program and frame the discussion by evaluating the nature and dimensions of the capital market imperfections. The heart of the analysis will consist of interpretation and analysis of privately managed institutional models such as privately organized savings bank consortia and the Massachusetts Capital Resource Company. The intention is to provide current evaluations of the degree to which states can harness the profit motive of private players to accomplish designated public policy objectives.
PART I:  CAPITAL MARKET IMPERFECTIONS: WHY SMALL BUSINESSES ARE BLOCKED OUT OF PRIVATE CAPITAL MARKETS

The Importance of Small Business

The role of small- and medium-sized firms in state economic development has only recently begun to be investigated. Initial findings underscore the role of smaller firms in providing sustained and rapid employment growth and the tendency of smaller firms as a class to show higher levels of profitability than larger and more mature firms. Approximately 50% of job placements can be traced to the births of new establishments and 50% to expansion of existing facilities. Close to 40% of those jobs created by the formation of new establishments are attributable to independent entrepreneurs. The rate of births and expansions of firms varies from region to region, accounting for net increases in employment by region.¹

Deaths and contractions of firms constitute a fairly stable percentage of decreases in employment across the country. The regions that grow are the ones that more than replace their losses with new and expanding firms. Job generation is an important dimension of state-wide economic development, and the job-generating role of smaller businesses is a matter of crucial importance for both the public and private sectors.
Smaller firms provide profitable investment opportunities as well as sources for net increments to employment. A recent study of the relationship between asset size and profitability for manufacturing corporations during the period from 1958-1976 demonstrated that in the two sub-periods, 1958-1971 and 1972-1976, the smallest corporations did quite well, outperforming all corporations from 1972-1976: firms with assets less than $10 million averaged a 14.2% rate of return on equity; those with assets greater than $100 million, a 12.3% return. The high profitability of small businesses as a whole, however, must be balanced against the individual variability of return found within the small business sector. Of the hundreds of thousands of new businesses that are started each year, over half fail. Since financial institutions make lending decisions based on the expected rate of return adjusted for risk, the profitability of smaller firms ought to encourage capital markets and individual lenders to be responsive to the capital requirements of smaller, younger companies. The volatility of smaller businesses increases risks to the lender, which should be reflected by a higher interest rate on small business loans. Imperfections in the operations of capital markets stemming from an unwillingness by lending institutions to
assume more than minimal risk on investments make it difficult for smaller, profitable, and more innovative firms to obtain needed financing at any cost.

The importance of smaller businesses as sources of technical innovation is well established and is underscored by the contribution that innovative firms, particularly high-technology businesses, make to general economic development ("Silicon Valley" in California and Rte 128 in Boston). The rate of sales growth and job creation is more rapid in innovative firms than it is in larger, more mature organizations. Larger corporations tend to use innovation to reduce employment by improving productivity in order to reduce costs and remain competitive. For smaller, technically based firms, innovation plays a critical role in the economic viability of the business and is responsible for the creation of new products, processes, markets, and employment. Capital market imperfections again reduce the availability of capital to innovative small enterprises, since lenders tend to consider innovation with which they are unfamiliar inherently risky and unstable. A closer look at the operations of the capital market will make it clearer why lenders refuse to finance profitable, rapidly growing, and innovative small businesses.
Capital Market Imperfections

Capital markets fail to operate efficiently whenever capital is not allocated to ventures on the basis of the expected rate of return adjusted for risk or when the lender is able to earn more than a competitive rate of return on assets. Risk arises from uncertainty about the expected rate of return—the more variable the possible rate of return around the expected return, the riskier the investment. A risk-neutral financial institution would be equally willing to lend to a risky venture with a higher rate of return as to a less risky venture with a lower rate of return. Large financial institutions tend to be risk-averse, however—that is they tend to minimize risk rather than to raise the rate of return. Investors will accept a lower rate of return on investments of lower risk and tend to use a relatively constant return on investment to screen out risky alternatives that do not balance the established rate of return. Smaller and younger firms—profitable and rapidly growing though they may be—tend to be riskier investments since it is difficult to determine which business will succeed and which will fail. Rather than raise the rates of return by increasing the interest rates on loans to smaller businesses, financial institutions simplify the investment process by
blocking out a whole class of potential borrowers--small businesses.

The unwillingness of institutional lenders to lend to riskier small establishments is exacerbated by a set of subsidiary capital market tendencies which increase the cost of lending to small firms or which prejudice lenders against new markets or technological and managerial innovation. Because it takes time and resources to arrange a financial transaction, lenders evaluate prospective investments after factoring in the costs of accumulating information on the firm and the legal and accounting costs of transacting the investment. Few small firms have established track records or credit ratings. This makes the acquisition of necessary information expensive to an institutional lender interested in minimizing overhead processing costs. Further, transaction costs represent a fixed cost to the lender for loans of all sizes so that the smaller capital requirements of smaller firms promise proportionately less return on investment than larger loans to larger firms. When information and transaction costs are very high--as they tend to be for smaller, riskier firms--lenders will make only the most advantageous investments if they make any at all.4
Lender prejudice against new markets and technological products makes the capital shortage facing rapidly growing, innovative producers ever larger. Investors often seek to reduce the information and transaction costs of investment by engaging in statistical discrimination to evaluate small business loan applications. In the end, money always passes between people, and it is the trust and confidence between lender and borrower which determines whether a particular investment is made. Institutional lenders often hesitate to finance new production techniques because of unfamiliarity with the complexities of the production process or because of unwillingness to accept highly specialized plant and equipment as security. The problem centers on judging by categories rather than by individual merit and on favoring the known over the unknown in order to hold down information and transaction costs. In the process, small businesses usually lose out.

Government regulations that mandate excessively conservative investment by lending institutions and pension funds also help to obstruct flows of capital to small businesses. Government regulations make it difficult and expensive for smaller firms to offer securities in the public capital market and force other capital market actors, such as pension funds, to exercise extreme caution in their investment decisions, effectively eliminating certain market investments.
in riskier small businesses. Private placement of debt and equity, particularly with commercial banks, offers somewhat greater opportunity to small businesses in search of capital, but private market risk aversion and a predilection for large investments in large companies limits the degree to which private institutions are willing to fill the smaller capital needs of smaller firms.

Small businesses play an important role as generators of jobs, tax revenues and innovative production processes. It is an important matter of public policy to develop mechanisms for rectifying capital market imperfections that threaten to limit the formation and expansion of these smaller businesses. Part II lays the schematic foundations for various institutional approaches.

PART II: STATE INTERVENTION IN CAPITAL MARKETS

Development planners recognize that public funds and public institutions alone cannot provide the necessary capital resources to sustain long-term economic development or the formation and expansion of small firms. State-sponsored development programs must encourage fuller private participation in economic development by leveraging maximum private involvement with a minimum amount of public intervention.
A state has three alternative policies to choose from when it wishes to encourage economic development within its jurisdiction: regulation, incentives, and intervention.

1. **Regulation.** As the charterer of state commercial banks, savings banks, savings and loan associations, insurance companies and such public fiduciaries as state and municipal pension funds, the state can impose regulatory requirements which have the effect of a) increasing or decreasing the availability of capital to those financial institutions and b) influencing the nature of their investments. Regulation can be passive in nature, consisting of bureaucratically administered rules, or active, involving the state as a public entrepreneur by chartering private institutions to pursue public purposes.

2. **Economic incentives.** The state can use an array of incentives such as interest subsidies, credit insurance, and secondary marketing devices to encourage private financial institutions to channel funds in socially desirable directions.

3. **Direct intervention.** The state can create publicly sponsored and funded development finance institutions such as industrial development agencies or direct loan programs.

State regulatory mechanisms and their potential usefulness in promoting small business development form
the focus of this paper. Compared to incentives and intervention, chartering and regulation provide relatively simple mechanisms that limit both cost and risk to the state. There are three characteristics of financial institutions on which state regulation is usually imposed: liabilities, or sources of funds; assets, or uses of funds; and market structure, or entry into and exit from the market. Regulation tends to be negative and passive--states impose restrictions on the operations of financial intermediaries in an attempt to force conformance to publicly determined policy. State regulation can be positive and active, using state initiative to facilitate the flow of funds from financial institutions to sectors of the economy that offer non-conventional yet profitable investment alternatives. States can use their chartering power to encourage the creation of privately managed and capitalized intermediaries and can mobilize economic incentives such as tax reform to stimulate such institutions to undertake more aggressive risk taking.

The balance of this paper will examine several institutions which provide valuable insight for designing publicly chartered but privately managed financial intermediaries whose pursuit of profit can be harnessed to achieve publicly desirable objectives. The creation of such intermediaries will allow states to move beyond their traditional and
relatively passive role as regulators of existing private financial institutions to a more active role as "public entrepreneurs."

The paper will examine and analyze existing models which use capital-market-perfecting techniques to reach segments of the economy which lending institutions tend to ignore. By increasing the availability of capital and by using standard market-perfecting approaches such as risk pooling and spreading to reduce risk-averseness, such state-chartered institutions will be able to help solve capital allocation problems that constrain small business formation and expansion.

PART III: MARKET-PERFECTING TECHNIQUES AND THEIR APPLICATION TO STATE-CHARTERED PRIVATE DEVELOPMENT FINANCE INSTITUTIONS

The primary market-perfecting techniques available to state regulators interested in harnessing the profit motive of the private sector consist of risk pooling, risk spreading, and the reduction of information and transaction costs. Risk pooling requires the gradual formation of a large and diversified portfolio of investments that capitalizes on the non-systematic risk of the marketplace. By making a spectrum of investments in various industries, in firms of various sizes, and in businesses facing different markets, a financial institution cushions its
portfolio against loss and uncertainty. An individual investor or financial institution reduces the overall risk of its portfolio through diversification because the higher risk of one investment is cancelled out by the lower risk of another. The rate of return on investment for the entire portfolio is an average of the risk of each separate investment, reducing the overall likelihood of loss. The reduction in overall risk makes the financier more willing to finance smaller businesses it would otherwise avoid.

Risk-spreading permits the risk of a particular investment to be shared among a large group of investors. Consequently, the potential loss to any one investor is reduced, allowing him/her to consider investments in riskier enterprises. Information and transaction costs can be reduced by decentralizing the operations of the institution or by staffing the institution with decision makers sufficiently expert to recognize proper investments with minimal data and sufficiently experienced in making investments in a particular segment of the market.

Private capital markets avoid investments in small businesses because risk and the costs of investment make such investments less likely to be as profitable as investments in larger businesses. In order for states to use privately managed and financed intermediaries to achieve
economic development objectives, they will need to do more than perfect those markets—they will have to provide sufficient incentives to make such intermediaries attractive repositories for private capital. Tax credits to individuals, tax reductions for an entire industry, or elimination of certain classes of regulation can be used as "carrot" or "stick" to induce private players to join with the state. Economic development planners must recognize that the private sector responds to opportunities for profit more quickly and efficiently than it does to calls to social virtue.

PART IV: PRIVATE INITIATIVES BY THE THRIFT INDUSTRY: NEW LIFE

Confronted by competition from commercial banks and threatened by reduced profit margins resulting from the need to provide competitive interest rates on deposits, thrift institutions are actively seeking to diversify their traditional portfolio of residential mortgages. To accomplish this result, thrifts have increased the volume of their commercial and industrial lending. By financing industrial expansion through provision of long-term mortgages to small- and medium-sized businesses, thrift institutions can exploit their familiarity with local economic conditions and fulfill requirements to make profitable mortgage loans while contributing substantially to regional economic development.
A consortium of 22 savings banks in western Massachusetts exemplifies this trend. New LIFE (Low Interest for Expansion) members participate jointly to provide industrial mortgages at rates below market to smaller- and medium-sized firms in order to facilitate expansion of facilities or to prevent plant shutdowns. New LIFE represents a privately initiated and privately financed example of the type of private-sector organization that state regulators can and should attempt to foster. New LIFE's member banks share the risk on any particular loan, cooperate to reduce the costs of accumulating information and transacting the loan, and voluntarily dedicate 1% of deposits to New LIFE loans.

Three points premise New LIFE's operations: 1) the private sector assumes the risk involved in development loans and therefore has an incentive to make those loans efficiently; 2) the system is decentralized so member banks can use their close ties to the community to reduce information and transaction costs; and 3) participating banks are able to satisfy socially desirable lending requirements while still maintaining required profit levels.

A closer inspection of the history, structure, and operations of New LIFE makes clearer the importance of its experience to state development planners.

The regional economy of western Massachusetts is characterized by a preponderance of mature, medium-sized
firms engaged in manufacturing paper products, machinery, rubber and plastic, and apparel and textiles—the very industries whose decline or geographical transfer has created serious economic problems throughout the Northeast. Extensive job loss during economic downturns—unemployment in the area reached 11% during 1974-1975—and plant shutdowns have occurred with accelerating frequency. Of the 30 largest industries in the Springfield, Massachusetts SMSA (which roughly corresponds to the New LIFE service area), employment fell in 10 industries between 1960 and 1970, and grew by less than 50% in thirteen others. The firms in the area generally are smaller and less stable than the kind of businesses that conventional lending institutions prefer to finance. The region has suffered from a chronic lack of long-term secured debt and equity capital for these firms.

Thrift institutions in the area gradually realized that the long-term viability and profitability of their own operations depended upon aggressively supporting the expansion of business activity and employment that forms their deposit base. At the initiative of John Collins of the Springfield Institution for Savings, the 22 savings banks in the area formed New LIFE in 1972. The consortium bases its operation on an extended application of the participation loan system framed within a set of social
and economic goals to guide its investment policy.

New LIFE members committed the organization to supporting job creation in the region by facilitating the expansion or retention of existing industry and the immigration of new industry. Loan applications are evaluated in terms of standard banking criteria—position of the firm within the industry, quality of management, historical earnings record—with an additional criteria that evaluates the number of jobs that will be created or maintained if the loan is made. Deals that offer a higher jobs-per-dollar ratio are favored over those with lower ratios. New LIFE limits its operations to providing mortgage loans and fixed-asset financing, usually at rates 2-3 points below prime. The consortium works with borrowers to obtain shorter-term, commercial bank financing to complement the longer-term capital it provides and to fill out their working capital needs. New LIFE views the lending process comprehensively and attempts to satisfy all the capital requirements of the older, smaller firms that form the industrial base of the region.

The New LIFE administrative structure is loose and decentralized, trading the efficiencies of a more centralized organization for the increased accessibility and adaptability of independent members tied together by the
participation principle. The member banks capitalized the original New LIFE fund by pledging 1% of their deposits, which in 1972 amounted to $15 million. In 1979, New LIFE funds totaled $23 million. By 1979, New LIFE had extended nine loans totalling $5.6 million, at interest rates ranging between 8-1/2% and 10%, preserving or creating over 1,250 jobs. (See Table I.) Consortium investment policy is gradually deemphasizing below-market rates: the Group has determined that access to capital is a greater problem for the region's firms than is the cost of capital itself.

New LIFE does not actively solicit clients. Firms seeking financing approach their local savings bank, usually after difficulty in arranging financing with commercial banks, insurance companies, venture capitalists, or governmental agencies. Loan applications suitable for inter-bank participation are referred to New LIFE's steering committee. This committee evaluates the proposal against criteria including financial strength of the applicant and the number of jobs preserved or created that can be attributed to the loan.

If the application is approved, the steering committee suggests arrangements specifying how the loan should be apportioned among member banks and how much of their pledge assets each participant will invest. Banks
### TABLE 1

**NEW LOW INTEREST FOR EXPANSION LOANS**

<table>
<thead>
<tr>
<th>COMPANY</th>
<th>LOCATION</th>
<th>PURPOSE</th>
<th>DATE</th>
<th>AMOUNT</th>
<th>RATE</th>
<th># BANKS</th>
<th># EMPLOYEES</th>
<th># EMPLOYEES</th>
</tr>
</thead>
<tbody>
<tr>
<td>Artell Mfg/ Everflex</td>
<td>Ludlow</td>
<td>E</td>
<td>8/74</td>
<td>411,000</td>
<td>9%</td>
<td>6</td>
<td>50</td>
<td></td>
</tr>
<tr>
<td>Leg-O-Matic</td>
<td>Palmer</td>
<td>N</td>
<td>7/74</td>
<td>555,000</td>
<td>8.3%</td>
<td>7</td>
<td>63</td>
<td></td>
</tr>
<tr>
<td>Presidential Realty</td>
<td>Palmer</td>
<td>N</td>
<td>7/74</td>
<td>210,000</td>
<td>9%</td>
<td>7</td>
<td>210</td>
<td></td>
</tr>
<tr>
<td>Hodge Mfg.</td>
<td>Springfield</td>
<td>E</td>
<td>12/78</td>
<td>650,000*</td>
<td>9</td>
<td>5</td>
<td>80</td>
<td></td>
</tr>
<tr>
<td>Facemate Corp.</td>
<td>Chicopee Falls</td>
<td>R</td>
<td>10/75</td>
<td>1,200,000</td>
<td>9</td>
<td>15</td>
<td>107</td>
<td></td>
</tr>
<tr>
<td>Forbes-Wright Industries</td>
<td>Monson</td>
<td>R</td>
<td>1/76</td>
<td>750,000</td>
<td>10</td>
<td>8</td>
<td>165</td>
<td></td>
</tr>
<tr>
<td>H.B. Smith Co.</td>
<td>Westfield</td>
<td>E</td>
<td>1/77</td>
<td>1,125,000</td>
<td>9</td>
<td>9</td>
<td>400</td>
<td></td>
</tr>
<tr>
<td>Yankee Coach, Inc.</td>
<td>Palmer</td>
<td>R &amp; E</td>
<td>10/78</td>
<td>325,000</td>
<td>10</td>
<td>3</td>
<td>56</td>
<td></td>
</tr>
<tr>
<td>Quabbin Industries</td>
<td>Chicopee</td>
<td>E</td>
<td>10/78</td>
<td>400,000</td>
<td>9%</td>
<td>4</td>
<td>150</td>
<td></td>
</tr>
</tbody>
</table>

5,626,000.

**E**=Expansion  
**R**=Retention  
**N**=New  

*Rewrite--original loan of $300,000 loan written in 1975.*

**SOURCE:** Figures furnished by William Jones, President, Springfield Institution for Savings, in an interview August 11, 1980.
generally determine their willingness to participate in
a particular loan by virtue of their proximity to the
borrower, their total available funds, and their risk
structure. The bank that referred the applicant to the
group becomes leader, investing the largest proportion of
its assets, and the terms of the loan are arranged by the
participating banks and not the consortium as a whole.
New LIFE strives to preserve the independence of member
banks by maintaining the flexibility in the decision-
making process and by relegating the determination of
loan terms to the lenders at risk.

A brief description of a particular New LIFE loan
transaction will serve to clarify the procedural operations
of the Group and the emphasis it places on job generation. 7
Quabbin Industries of Chicopee Mass. is a specialized
manufacturing producer whose primary markets include the
power generation, shipbuilding, and chemical industries.
In 1974 the firm operated two small plants in western
Massachusetts, employing approximately 40 workers. At
this time Quabbin began to experience financial difficulties
relating to its debt structure. By 1978 the firm had
invested $350,000 in building improvements financed by
short-term loans from commercial banks. The company
needed to expand and required an infusion of working
capital but had reached its commercial bank credit limit. Quabbin specifically desired to restructure its debt by replacing short-term loans with a mortgage loan amounting to $600,000. Quabbin approached a local savings bank which referred the application to the New LIFE steering committee. New LIFE offered a $400,000 mortgage for 15 years at 9-1/2% and helped to arrange a simultaneous commitment for $200,000 in senior notes from the Massachusetts Capital Resource Company (see Part VII). Four member banks participated in the loan—a somewhat risky transaction considering the highly leveraged structure of the firm. Fifteen new jobs were created in 1978 and 50 more in 1979. New LIFE intervention was quick—the Quabbin mortgage was transacted in less than 6 months—and essential: Quabbin's highly leveraged structure made commercial banks unwilling to accept the risk involved in financing the expansion.

New LIFE is a capital-market-perfecting private sector innovation. By spreading the risk of a particular loan among several participating banks, New LIFE limits the risk exposure of any one member to a manageable level so that the consortium cooperatively takes on risky investments that would be rejected individually. New LIFE institutionalizes risk pooling—the portfolio of loans
held by member institutions includes a diversified group of borrowers whose loans vary in their degree of risk. The Group's fluid and decentralized structure significantly reduces the high information costs associated with small business lending since the close community ties of member savings banks permit them to share their knowledge of the business community with the entire consortium. Transaction costs have not been significantly reduced by the Group's operations. New LIFE has, however, been able to establish certain loan procedures that make mortgage processing relatively quick and painless.

Since 1978, New LIFE operations have been substantially affected by the vastly expanded industrial revenue bond program sponsored by the Massachusetts Industrial Finance Agency. Loan applications have dropped during the last two years because the kinds of firms which form the potential market for New LIFE member banks have been attracted to the interest subsidies provided through tax-exempt bonding. Potential New LIFE borrowers can obtain lower interest rates for their mortgage loans by using revenue bonds than they can by arranging a New LIFE loan directly. Since participating banks have little need for tax-exempt income, they have no incentive to purchase bonds issued through MIFA to finance plant expansions in western
Massachusetts. Policy makers interested in adopting the New LIFE model should be aware of its susceptibility to competition from revenue bond programs. The substitution of publicly subsidized dollars (through IRBs) for private market capital is a problem that must be addressed by any policy attempting to promote economic development.

New LIFE has been able to provide financing to a class of small firms whose age or size precludes access to capital from conventional lenders in the area. The consortium offers a particularly useful mechanism by which savings banks can fulfill their obligations under the Community Reinvestment Act to meet the credit needs of local borrowers. Its success in enabling savings banks to provide capital at reasonable rates to small firms whose riskiness would otherwise preclude financing is easily replicable throughout the country, especially in urban areas where small business lending is particularly complicated.

An evaluation of New LIFE would emphasize the following issues:

1. New LIFE provides long-term debt financing to relatively risky small businesses traditionally blocked out of capital markets.

2. New LIFE is a genuinely market-perfecting mechanism: it enables savings banks to pool and spread risk and induces them to take on mortgage commitments they would otherwise refuse.

3. New LIFE relatively autonomous and decentralized operations provide flexibility and a deeper knowledge of local needs.
4. New LIFE ties the profit motive of the private sector to the publicly desired objective of increased employment and business activity (which generates additional tax revenues).

5. New LIFE does not involve the placing at risk of public monies nor does it entail the expenditure of public funds in the form of incentives or subsidies.

6. New LIFE is simply structured and has no special ties to particular industries or communities. As such it is easily replicated wherever sufficient numbers of banks exist to elaborate on the traditional participation principle.

The most important criticism of the Group's performance has been the relatively unambitious manner in which New LIFE has attempted to commit the full funding it has at its disposal from member banks. When fully operating, the Group had placed approximately 60% of its available resources. A permanent staff working through a central office could have publicized the Group's activity, freed it from dependence on member referrals, and expanded its ability to lend up to capacity.

The economic costs associated with New LIFE operations are borne by the member banks themselves—Group members internalize the opportunity costs that come from below-market rate lending and absorb the relatively high transaction costs that result from New LIFE's fluid administrative structure. The economic benefits of the consortium's operations, however, are diffused throughout the New LIFE service area—general increases in business
activity and employment provide positive contributions to the region's economic well-being that are not captured by the profits member banks make from their loans. New LIFE's operations reveal remarkably few problems or complications. It does what it does well, and merely needs to do more of it.

PART V: MASSACHUSETTS LENDING CORPORATION (MLC): NEW LIFE ON A STATEWIDE LEVEL

The success of New LIFE during the last eight years encouraged Massachusetts lending institutions--commercial banks as well as thrifts--to consider its replication on a statewide level. To several influential bankers throughout the state, the extended participation principle on which New LIFE is based seemed an appropriate vehicle for pooling the vast capital resources of the state's banking system and for coordinating investment in economic development and job-generating projects. Although the Massachusetts Lending Corporation (MLC) has not yet been established, its structure and purposes have been sufficiently sketched out to make a discussion of its relevance to small business financing worthwhile.

The proposed MLC is an example of the supportive role that state regulators can play by sponsoring publicly chartered but privately managed and financed development institutions. It represents active regulation, regulation...
that seeks to capitalize upon private sector initiative rather than constrain it with passive restrictions.

The MLC concept proposes a privately owned corporation, funded by stock purchases by participating banks, directed to make secured real estate and equipment loans to commercial and industrial firms in order to stimulate economic growth and development. State law would create a central lending facility open to voluntary participation by all state-chartered lending institutions. No public appropriation would be required, and the credit of the state would not be pledged in support of MLC operations.

The Lending Corporation would utilize standard capital-market-perfecting techniques—risk pooling and spreading, and decreased transaction costs. The MLC would 1) professionally package and evaluate secured lending opportunities, either independently or in collaboration with state development agencies; 2) coordinate the investments of the MLC with public sector activities; 3) encourage the diversion of out-of-state investments into Massachusetts commercial/industrial development; and 4) facilitate the inclusion of small- and medium-sized banks in large-scale development financing.

The Lending Corporation would be charged with financing the construction, expansion, and/or improvement of physical plant either through direct lending to eligible
firms or by investments in the obligations issued by development finance authorities. The MLC would be capitalized by separate stock purchases by four categories of lending institutions: commercials, thrifts, cooperatives, and credit unions. It would be permitted to incur debt up to a debt-equity ratio of 10:1. Stockholders establish lines of credit to the MLC, irrevocable for five years, and agree to subscribe to loans of particular interest. Stockholders also commit themselves to make eligible loans, directly or through the Lending Corporation, upon call of the Corporation's Board of Directors in amounts and upon terms designated by the MLC. Stockholders may periodically be required to fund pro-rated portions of undersubscribed loans, though no member can be required to make investments not permitted under its chartering regulations. The State Banking Commissioner would exercise broad supervisory and regulatory powers over MLC operations.

Massachusetts Lending's structure represents an attempt to standardize and channel both the flow of institutional funds into productive investments and the flow of information among the various financial intermediaries capable of financing economic development. Two points concerning MLC's investment strategy remain unclear: to what degree will MLC favor larger physical development projects over the capital needs of smaller firms, and to
what extent will its sources of funds (from fairly conservative lending institutions) and its debt structure constrain the uses of those funds. Pressures within the MLC may make it difficult for the corporation to internalize the opportunity costs associated with smaller-sized investments, though central staffing and procedures ought to reduce transaction costs. Further, the diverse geographic locations of stockholders ought to reduce information costs.

Capital substitution issues also are important since one expressed objective of the MLC is to encourage the in-state investment of funds now exported to other regions. To the degree that MLC lending displaces investments that member banks would have made independently, no net increase in investment occurs.

It is conceivable that MLC operations would appear sufficiently remote, because of its statewide mandate, from the investment needs and preferences of local institutions that it would fail to attract enough stockholders to accumulate large enough capital reserves to have a meaningful effect on state economic development. Development finance intermediaries should be capitalized with enough money to directly affect economic development, and not be swamped by larger market forces that would make what investments are made insignificant. New LIFE's economic benefits, indirect though they may be, are readily visible to member
banks who can see the tangible results of their investments in regional development projects. It is difficult to imagine small banks in the southeast part of the state recognizing the indirect benefits of investments in the northwest, though direct return on investment may be large enough to satisfy them and attract enough stockholders to MLC.

The intention behind public chartering but private managing and risk taking is to harness the pursuit of profit to public ends. For this approach to succeed, the profit must be substantial and readily apparent. An alternative to the MLC structure would be a network of regional consortia, organized like New LIFE, that use a central coordinating office to transmit information or manage particularly large investments while leaving regional groups to provide financing within their own service areas. A network organized along these lines would preserve local flexibility in investment decision making, while the central facility would insure that necessary larger loans were also made through inter-regional cooperation. The MLC concept promises to provide coordination of lending activity and to facilitate the formation of fluid capital reserves, but at the risk of limiting local initiative and flexibility in lending.
PART VI: THE MAINE CAPITAL CORP. (MCC)

The conceptual framework behind the Mass Lending Corp.--public chartering for private sector initiatives--can be reformulated to address more directly the capital needs of small business. Mass Lending depended on state action to provide the structural framework for what was essentially a privately financed economic development innovation managed by experienced institutional lenders. State chartering can take on a more powerful organizing role while still leaving enough initiative and flexibility to private sector actors so that it is profitable for them to pursue publicly desired economic development objectives. Private sector pursuit of profitable returns remains the important motivation, yet the state plays a greater role initially in determining the ends toward which private actors move and the sorts of incentives used to get them involved. Two groups of actors are important--individual investors and institutional lenders. Two kinds of incentives are available--tax credits to encourage particular sorts of investment (the "carrot") and industry-wide tax reform contingent upon fulfillment of certain investment obligations (the "stick"). The Maine Capital Corporation uses tax credits to individual investors to induce them to participate in economic development lending, and
represents an example of active state chartering to direct investments to smaller businesses.

Maine's economy is historically weak. The state suffers from chronic unemployment at levels well above the national average. The state's manufacturing sector is composed of large numbers of small businesses and is focused on exploitation and processing of the state's natural resources. Maine's capital market is small and uncoordinated: there are a few "old money" venture capitalists and only one major insurance company. Commercial banks in the state prefer to provide secured short- and medium-term lending. Capital market imperfections limit the availability of equity and long-term debt to the state's small business sector, which restricts the growth of jobs and revenues. In 1977, the state legislature recognized that the lack of equity capital to finance new and/or expanding business ventures presented severe obstacles to statewide economic development since it forced small businesses to rely on debt capital with its regular service demands.

To begin to rectify the situation, the legislature established the Maine Capital Corporation, a publicly chartered venture capital company. The MCC capitalizes on the profit motive of private investors to facilitate expanded economic development: the Corporation pools
private capital and invests it in profitable ventures, simultaneously pursuing a good return on investment and the public purpose of a strengthened state economy. It is an investment corporation charged with investing equity funds in businesses in order to "enhance their productive capacities" or to facilitate their ability to generate value-added on goods or services for export to out-of-state markets.

Maine Capital is capitalized at $1,000,000 consisting of 10,000 shares of common stock with a par value of $100 per share. Investment in the MCC is restricted to a maximum of 1000 shares per person or firm and is encouraged by the provision of limited tax credits for investors who purchase MCC stock. The Corporation's maximum investment in business establishments is limited to $200,000. The MCC may not declare dividends during the first five years of operations, and subsequent payment of dividends cannot exceed 50% of retained earnings, the balance to be reinvested in eligible ventures.

The MCC investment tax credit represents a direct involvement by the state not present in New LIFE or Mass. Lending. The state induces investors to buy shares in Maine Capital by providing a tax credit, equal to 50% of their investment in MCC, against state income taxes for individuals and
corporations. Investors can credit 10% of their MCC investment against income taxes each year for five years. The tax credit represents an indirect contribution by the state to MCC capitalization since the $500,000 (50% tax credit x $1 million MCC capitalization) in foregone tax revenues accrues to the benefit of the Corporation. Thus, the success of MCC must be measured against the benefits that would otherwise have been generated by the state expenditure of the credited taxes. The important consideration remains that private investors have accepted the risk involved in venture capital lending. Further, the state has minimized its regulatory involvement with the Corporation, which maintains a quasi-public status. The state refrained from including restrictions on targeting investment to particular regions or to particular types of businesses, other than to restrict MCC investments to common and preferred stock or debt convertible to stock or rights to purchase stock.

An organizing committee appointed by the governor contracted a professional management firm to oversee MCC investments and to provide technical assistance to start-up ventures financed by the Corporation. MCC managers decided to seek licensing as a Small Business Investment Corporation in order to increase the impact of MCC's limited capitalization: as an SBIC, MCC can leverage up
to $4,000,000 in federal funds. This will enable Maine Capital to provide comprehensive financing packages including subordinated debt as well as equity.

General outlines of the MCC investment strategy include 1) diversifying its portfolio in terms of size, product, and maturity of companies; 2) aggressively pursuing risk-taking investment strategies with their potential for large gains; and 3) investing in company expansions, buy-outs, acquisitions, and start-ups while avoiding "rescues" with little chance of success. Maine Capital intends to subordinate job generation to a secondary consideration, focusing instead on evaluations of profitability and a determination of the degree to which MCC equity investments make it easier for companies to achieve greater access to long-term debt.12

The Maine Capital Corporation's operating policy closely fits its investment strategy. MCC will seek multiple participation in investments, acting as lead partner in a syndicate to maximize leveraging and to reduce risk exposure. One problem that complicates venture capital investing, both public and private, is arranging to sell equity interests in a firm after a reasonable period of time in order to reinvest the original investment and realized capital gains in new ventures. MCC will attempt to preserve the liquidity of its investments by structuring its participation
so that its exit is pre-arranged to occur at approximately five years. The Corporation intends to establish reserve funds for each investment by committing somewhat less than the maximum permissible amount per deal. Further, returns on investment will be structured so as to cover the debt service costs associated with the investment. MCC expects to return the appreciation on equity to its stockholders through distribution of shares in MCC portfolio companies and through payments of dividends after the fifth year.

The Maine Capital Corporation represents a relatively small effort to broaden the base of the capital market in Maine. Given the small size of the market, the MCC should be able to exercise a sufficiently large market-perfecting role. MCC spreads and pools risk that would otherwise overwhelm an individual investor, though MCC's equity capitalization is not a large pool and the maximum number of investors is relatively small due to restrictions on the way in which MCC stock was marketed. In short, MCC will be an imperfect innovation.

MCC coordination of investments that individual investors would have made on their own results in substantial savings and efficiencies in information and transaction costs but raises questions about the degree to which MCC investments result in new investment and not merely displacement. MCC's incorporation into Maine capital markets
will provide a source of sorely lacking equity capital. However, its determination to leverage its investments with subordinated debt through an SBIC may serve to limit the kinds of ventures it finances. The highly leveraged position of the SBIC will force MCC to finance only those firms capable of immediately meeting debt service schedules, which is usually difficult for newly established firms.

The Maine capital market is small, and capital is concentrated largely in commercial banks. Thus, to the degree that the presence of Maine Capital helps to reduce financial market concentration, it will increase capital availability to small businesses currently dependent on commercial bank debt. Further, to the degree that MCC management is able to identify profitable investments early on and to take the kinds of risk necessary to ensure good returns on investment, it will succeed in increasing its pool of funds available for investment and magnifying its impact throughout the state. Finally, to the degree that MCC is able to promote economic development without using state revenues and to take the sorts of risk that state-financed and state-managed bureaucracies are unable to take, the Maine Capital Corporation will succeed in mobilizing private sector resources and initiative efficiently and inexpensively.
PART VII: THE MASSACHUSETTS CAPITAL RESOURCE COMPANY (MCRC)

New LIFE, Mass Lending, and Maine Capital operate along similar lines—the private sector capitalizes a development finance intermediary, makes investments for private profit, assumes the risk associated with such investment, and operates within the relatively few restrictions established by state regulation or chartering. The convergence of private profit and public policy makes the arrangement desirable from the viewpoint of public officials, since the public sector realizes certain development benefits that come from private sector initiative and efficiency. New jobs and revenues result to the state. Public sector involvement, in terms of the commitment of resources and administration, is minimized.

State regulations, however, can adopt the publicly chartered/privately financed framework even more stringently than it is used in the MCC case. By explicitly incorporating specific investment criteria into the charter, legislators and public administrators can direct investment to carefully designated categories of businesses or to particular regions. To induce private sector actors to become involved in an arrangement that restricts investment flexibility and, therefore, increases risk, the public sector can offer a large quid-pro-quo in the form of large-scale tax reform.
or incentives. These can be given either before investment (the carrot) or contingent upon fulfillment of investment obligations (the stick).

The Massachusetts Capital Resource Company represents a state level model of such an institution. Its operation is larger and more complicated than any of the previously described models. MCRC is a $100 million dollar privately capitalized investment corporation, formed in 1977 by a consortium of eight Massachusetts-based life insurance companies. MCRC was the product of negotiations between the life insurance industry and the state. Taxes on the industry's investments and premiums were reduced in return for a commitment by the industry to capitalize a privately managed institution charged with providing capital to small- and medium-sized businesses. Access to capital for small businesses has been made difficult by imperfections in the New England capital market.

Life insurance companies play an important institutional lending role in private capital markets. As providers of private placement capital (investments negotiated individually between a particular borrower and the insurance company), life insurance companies control a large pool of capital potentially more accessible to small businesses than the public stock and bond market or commercial bank lenders. Private placement investing can be arranged
fairly rapidly and at prices more favorable to small borrowers, though insurers often demand terms that provide them with some control of management. Despite this potential, life insurance companies make their investments in a way that reinforces capital market imperfections: they tend to concentrate their investments in only the largest firms. A study by the Massachusetts Department of Banking and Insurance in 1977 determined that "life insurance companies, like other institutions, tend to concentrate their investments on a relatively small number of stocks and bonds having large market values." Life insurance companies seek stability of earnings (among other objectives) in order to preserve solvency and evaluate investments by measuring them against quality, liquidity, and risk criteria. The result is that insurance companies effectively exclude debt obligations below BA quality and most corporate equity, prefer readily marketable bonds and government securities, and avoid the relatively risky opportunities presented by small or unfamiliar businesses. Small firms, therefore, find it as difficult to tap this potential source of capital as they do the public capital markets.

In order to promote lending to and investment in small businesses, the Massachusetts state government attempted to respond to a decade-long campaign by domestic life
insurance companies to have state insurance taxes restructured. Massachusetts had taxed its life insurance industry relatively heavily since 1969: until 1977, Massachusetts insurance taxes were three times higher than the next highest state (Connecticut) and five times higher than the national average. In 1969 the state levied a 14% surtax on the existing 2% premium tax levied against both domestic and out-of-state insurance companies. At the request of domestic insurers, who wished to avoid costly retaliatory tax payments to other states, the tax was changed and a 41% surtax was levied against domestics only amounting to an effective rate of 3.2%. In 1971 the state initiated a 1% tax on gross investment income (GIT) of domestic insurers, a 14% surtax to cover the charges that would have fallen on foreign companies, and a 2.28% tax on annuities (a relatively insignificant levy).

Domestic life insurers claimed that the entire structure of state taxes, particularly the GIT, put domestics at a competitive disadvantage and was unfair both in comparison to state tax treatment of other industries and to treatment of life insurance companies in other states. The increased tax burden does not seem to have caused a decrease in the growth of premium receipts before 1977 (which were decreasing for a variety of reasons) but may have adversely affected domestic companies' ability to
draw large institutional group annuities whose investment decisions are highly price-sensitive. By 1977 a legislative consensus had emerged that favored a tax restructuring, but a restructuring that would be part of a larger agreement affecting life insurance company investment practices.

The agreement that resulted in the formation of the Massachusetts Capital Resource Company (MCRC) emphasized 1) the gradual introduction of an allocated net investment tax to replace the GIT; 2) an acknowledgement of the capital-financing problems confronting small business; and 3) a determination by the state to use its taxation and chartering powers to tie the investment expertise and resources of life insurance companies to public gain. The tax restructuring included: freezing expected state revenues from both domestic and foreign life insurance companies at the 1978 level through 1983, repeal of the 2.28% annuity tax, gradual decrease of the premium tax on domestics from 3.2% to 2%, suspension of the GIT and ultimate repeal contingent upon specified MCRC investments, and application of the net investment tax at decreasing levels, again contingent on certain MCRC investments.

The approach taken by the creation of MCRC is similar to other models discussed previously in that a privately financed and managed intermediary chartered by the state
pursues profit-motivated investments that result in tax and employment benefits to the public sector and to specified categories of private sector businesses. MCRC differs in the degree to which state regulations have 1) defined specific categories of "eligible" investments; 2) clearly designated job creation and preservation to be MCRC's primary investment objective, and 3) made the realization of tax reform contingent upon MCRC performance.

The elements of the MCRC framework make it a larger and more complicated version of the publicly chartered/privately financed model for providing capital to small businesses. The eight largest life insurance companies in the state will provide MCRCs $100 million capitalization by contributing pro-rate shares to the $20 million annual contributions required between 1977 and 1982. For the life insurers to receive the phasedown of the net investment tax, MRC investment in qualified businesses must meet the following investment schedule mandated by the chartering legislation:
MCRC investment in "qualified businesses" reflects the determination of the state to direct capital, via the life insurance industry, to businesses effectively locked out of the capital markets.

MCRC is required to evaluate loan applications in terms of the business's ability to obtain capital on similar terms from conventional lenders. MCRC applicants must attempt to obtain financing on similar terms from three other sources before it will be considered for financing. MCRC is not required to invest in marginal firms—in fact, its evaluation criteria aim to select only those businesses whose history and management warrant investment. It is required to make unsecured loans to small firms whose size or product make it difficult to obtain capital, but whose
potential for growth and profitability is good. Specific investment guidelines prohibit investment in real estate development, public utilities, construction contracting, or retail trade.

Having satisfied these general limitations, Mass Capital must restrict its placement to:

1. debt and equity of businesses whose senior debt is rated Baa or below;
2. investments with a maturity greater than five years;
3. investments up to a maximum of $5 million.

MCRC must reserve at least $3 million to invest in firms that meet the eligibility requirement of a small business investment company (SBIC). Further, MCRC can establish a reserve of up to 25% of loanable funds for secured loans, debt with maturity less than five years, and certain investments made through a financial intermediary. MCRC's charter also establishes job-performance quotas for 1981 to 1983 of 4,000 direct jobs maintained or created.16 Tax penalties are prescribed for shortfalls from this target. Should MCRC not be able to find sufficient placements to meet its schedule it may invest up to 10% of total contributed capital in short-term securities, though such investments cannot be counted against "qualified" requirements.

MCRC operations are managed by a team of five investment specialists, and investment decisions are reviewed by an investment committee which includes a public member.
appointed by the governor. The State Commissioner of Insurance must certify MCRC investments to ensure compliance and the Secretary of Manpower Affairs must certify the number of jobs created by MCRC investments. MCRC's partners may suspend operations before 1983 should the state renge on its tax reform commitments and may liquidate the company after 25 years.

By July 1980 MCRC had made thirty-seven qualified investments totalling over $34 million; 27 of these fit the SBA definition for small business. The average loan amounts to over $900,000 with a range of between $125,000 and the statutory maximum--$5 million. The average maturity of each deal is just under eleven years. MCRC has been contacted by over 800 companies during its first 2-1/2 years and has concentrated its resources on providing subordinated debt to a range of firms, though 30%-40% of investments have been placed with high-technology related businesses.

MCRC does not release information concerning its borrowers or the terms of its financing packages, though an estimate of the size of its clients points to annual sales volumes averaging from $5 to $10 million. Loans carried in the MCRC portfolio are substantially more risky than investments usually made by life insurance companies. Consequently, the general partners expect a somewhat higher level of default than life insurers usually experience.
Dan Holland, MCRC President, believes that the final evaluation of the Company must await a longer-term assessment of the portfolio's rate of return. He feels that realistic measurements will emerge only after 7-10 years.\textsuperscript{18}

MCRC evaluates applications using standard criteria—position in industry, management capability, and type of product. The Company is concerned with the employment impact of its lending and rejects applications that fail to provide adequate job growth possibilities. MCRC processing is fairly quick—as short as a month for a well-documented application. Given the relatively unknown backgrounds of most applicants (who tend to be smaller and newer), MCRC must absorb high information costs.

MCRC works closely with prospective borrowers to tailor loan packages to the particular needs of its clients, and attempts to use subordinated debt to help firms raise additional equity. The subordinated debt is used to leverage longer-term debt from conventional lenders since such lenders consider subordinated debt to be "effective equity." Because banks are usually willing to make more debt available to firms that are well-capitalized with equity, MCRC's ability to take a junior position to more senior bank loans increases the ability of MCRC borrowers to arrange private-sector financing. MCRC financing can help to legitimate small businesses in the eyes of conventional investors who perceive
MCRC evaluations to be accurate and in-depth.

Because MCRC is difficult to categorize as a financial institution, it is difficult to trace a particular investment strategy. It is neither a bank nor a venture capital firm, and its portfolio includes loans made for start-up as well as expansion, though the Company appears to emphasize the latter. Two brief examples of MCRC lending demonstrate its effectiveness in providing capital to firms traditionally locked out of private capital markets.

In 1978, MCRC invested $350,000 in secured notes in Agromarine Industries of New Bedford, a newly created fish processing company which concentrates in underutilized species for export overseas. The project had the support of the local business community and of government agencies. The MCRC investment completed the financing package required to enable the plant to begin operations. MCRC's investment resulted in 145 new jobs. MCRC also invested $100,000 in junior subordinated notes in Semicon, Inc., a semiconductor manufacturer which required long-term (15 years) funds to complete its five-year expansion plan. The loan is expected to support 220 new jobs during the expansion phase. Both of these loans illustrate the unconventional and market-perfecting nature of MCRC's investments--Agromarine might never have been able to begin operations without its MCRC infusion. Similarly, Semicon was able to arrange filler
capital on unusually favorable terms for a relatively small firm in the highly competitive high-technology field.

An evaluation of Mass Capital's first 2-1/2 years must necessarily be grounded on incomplete data. It is clear, however, that what success MCRC has had to date in making capital available to small businesses can be attributed to:

1. sufficient incentive, in the form of substantial tax reform, to motivate the private sector to make investments it might otherwise ignore;

2. expert and experienced management; and

3. large enough capitalization to have a real impact on its target businesses.

The size of the tax relief package contingent upon MCRC fulfillment of its obligations is difficult to estimate over long periods because of the uncertainty of the multiplier effects of jobs created by MCRC investments. The best estimate, made by the Department of Revenue, points to a revenue loss to the state of $81 million between 1977 and 1987, even after incorporating a projected $62 million growth in revenues from taxation of out-of-state insurers. The tax package reduces the annual growth in revenues from domestic taxation from $1.6 million (pre-1977) to $0.7 million after 1981. Taxes paid by domestic insurers will not reach the 1976 peak ($25 million) until sometime during the 1990s, though substantial growth in revenues from
foreign insurers will cause total state revenues from the insurance industry to increase beyond 1976 levels by 1987. Since MCRC profits on investment are ultimately redistributed to the life insurance companies that capitalized it, tax benefits and profit taken together amount to a substantial, if unquantifiable, figure, one large enough to induce MCRC to operate as efficiently and responsibly as possible.

Whether the tax reform package benefits the state as much as it does the insurers (since MCRC's capitalization may be thought of as a transfer from the state via taxes foregone) rests on an evaluation of the Company's ability to create and maintain jobs in the state.

The primary reason for the creation of MCRC was to create jobs. It is a requirement of the Company's charter that MCRC seek to determine "the number of jobs reasonably expected to be maintained or created as a direct result of qualified investments by the Company." The Secretary of Manpower Affairs is charged with certifying the estimate. Such a determination, however, relies heavily on information and conjecture supplied by MCRC applicants. MCRC does not require independent verification of figures supplied to it. Job accounting is a difficult procedure to develop, but given the job-creating mandate of MCRC's charter, an important one. Several possible approaches present themselves. MCRC could use a ratio of capital contributed by
MCRC to the firm's total capital and allocate job creation proportionately. Alternatively, it could determine the degree to which MCRC made available capital beyond its contribution by "freeing up" the borrower's capital structure with subordinated debt and adjust its allocation accordingly.

A memo drafted by Peter Jones, the public member of MCRC's Board, in 1979 suggests that the Company ought to determine what part of a borrower's balance sheet consists of capital of a sufficiently permanent nature that it is employment supporting and derive its capital contribution ratio on that basis.²⁰ The point, however, is that whatever method is used, job accounting is such an important part of evaluating MCRC's success and for determining the benefits to the state that accrue from its tax restructuring that the state should develop a post-audit system for assessing job generation independently.

MCRC's success in packaging its investments rapidly and in placing loans with a variety of small businesses can largely be attributed to expert management. The Company is flexible and works closely with its clients, seeking to develop the kind of financing most appropriate for a given firm at a given time. By effectively using risk pooling and spreading to reduce the risk it faces on small business lending, MCRC succeeds in surmounting obstacles that prevent capital markets from operating efficiently.
MCRC managers are willing to absorb relatively high information costs. To the degree that it learns to choose the right deals early on, MCRC will begin to show returns on investment that will make regular small business lending attractive to the insurers that funded the Company. MCRC's close evaluation of prospective borrowers and its determination to make profitable investments help to legitimize its clients in the eyes of conventional lenders and confer a certain acceptability that makes it easier for its borrowers to top conventional financing in the future.

MCRC has a large enough pool of capital to enable it to have an immediate effect on the expansion plans of smaller businesses. Though 37 investments is a very small part of the market, MCRC's commitment of $34 million in 2-1/2 years is a rapid commitment of funds by any standard. Massachusetts financial intermediaries have billions of dollars available for investment, of which MCRC's $100 million is a small part. Compared, however, to other public and private development finance intermediaries (e.g., Maine Capital), MCRC looms large and will continue to support substantial industrial expansion by small firms.

MCRC is the most complicated of the four models discussed. The particular conditions that determined its structure and operations may limit its replicability to
other regions. The concept behind MCRC, however, does have relevance to other states. A bill pending in Alaska builds upon the "public entrepreneur" concept of state regulation. Under provisions of the bill, the state would eliminate gross premium taxation for any domestic insurer which invested 50% or more of its premiums in the state. Though the bill does not establish an independent entity to hold and invest insurance industry funds, it does acknowledge the importance of using state regulatory powers to harness the resources and profit-seeking behavior of private-sector actors to public policy ends.

**PART VIII: POLICY RECOMMENDATIONS**

The following recommendations represent a synthesis of policy issues presented in this paper:

1. Small businesses are an important feature of any state development program. However, they face obstacles in the capital markets that deny them access to capital. States should use market-perfecting techniques such as risk pooling and spreading to reduce the obstacles to small business financing.

2. State development planners should reduce the degree to which public revenues must be placed at risk to finance small business development programs. By capitalizing on the profit motive of the private sector, states can substantially reduce the appropriation of public funds and harness the efficiency of private management and financing.

3. The "public entrepreneur" approach rarely involves direct outlay of state revenues, though some models require initial tax expenditures. The benefits that accrue to the state in the form of leveraged investment, newly
created or maintained jobs, and the generation of new tax revenues can ultimately justify initial cost to the state.

4. Successful development institutions are managed by administrators who 1) make riskier investments than conventional lenders or investors, 2) direct their investments to limited categories of small firms unable to find funds in the private sector, and 3) explicitly incorporate employment potential into loan evaluations.

5. New LIFE, the Massachusetts Lending Corporation, and the Maine Capital Corporation seem especially adaptable to a variety of situations. New LIFE and Mass Lending could operate successfully wherever the banking and credit system of a region is well established, and the business sector is willing to join voluntarily with the public sector to pursue mutually profitable development finance efforts.

6. The complexity and uniqueness of MCRC make its replicability more uncertain though high-tax states willing to provide sufficient incentives in the form of tax-restructuring should be able to induce a particular industry to form a fund similar to MCRC.

The importance of each model discussed in this paper lies in its ability to direct capital to small, new, and/or technologically oriented businesses. The objective is to provide that capital efficiently, profitably, quickly, and with minimal direct cost to the state.
NOTES


6Kate Day, Bill DeSante, and Babs Racca, "New LIFE," unpublished manuscript, Department of City and Regional Planning, Harvard University, 1979.

7Ibid.

8Interview, William James, President, Springfield Institute for Savings, August 1980.


11Maine Statutes, 10 MRSA Chapter 108, "The Maine Capital Corporation."

12Maine Capital Corporation, "Private Placement Memo" (draft) for offering of stock in the Corporation, Augusta, ME, 28 November 1979, p. 22.

13Interview, Lloyd Brace, Maine Capital Corporation, 8 August 1980.


17 Gleisser and Kornetsky, "The Massachusetts Capital Resources Company: The First Year."

18 Interview, Daniel Holland, President, Massachusetts Capital Resources Company, 8 July 1980.

19 Massachusetts General Court, House Bill 6257.

ADDENDUM

Additional Notes to "The State as 'Public Entrepreneur': Public Chartering of Privately Financed Development Institutions."

p. iii. "... lenders have difficulty predicting which ventures will succeed and which will fail." from: