Virginia's
Rural Economic Analysis Program

HORIZONS

July/August 2003 Volume 15 Number 4

The Contribution of Virginia's Capital Access Program to Rural Development

Wayne D. Purcell

The 2000 Virginia General Assembly passed a resolution establishing the Rural Virginia Prosperity Commission. Motivation for the high-level commission came from growing evidence that rural Virginia was falling behind urban sectors in economic activity, growth, and general well-being. The Commission's December 2001 final report offered several recommendations to help rural Virginia grow. No one program or policy has the capacity to cure pervasive problems of low income, families living in poverty, low levels of educational attainment, and meager levels of new investments in the rural sectors of the Commonwealth. But Commission members generally agreed that if any one of the recommendations might have stand-alone capacity to help, it would be the recommendation for expanded support of the Virginia Capital Access Program in the Virginia Small Business Financing Authority in the Virginia Department of Business Assistance.

Earlier REAP research established that borrowing money to grow small businesses in rural communities is often difficult. Loan requests from ongoing businesses are being turned down (Kruja, Mundy, and Purcell). The relatively small loan is hard to get. Banks face about the same costs per loan for a $50,000 loan as for a $5.0 million loan. This cost obstacle to the capital needs of small businesses has often been compounded by the lack of collateral required by the long-standing ratios driving business loan approvals. An attractive cash flow potential in a business plan does not meet the sufficient conditions for being able to borrow money. Often, collateral is the key determinant as to whether the bank will extend the credit.

In an economy that is increasingly service-based and moving away from the traditional manufacturing approaches, the issue of collateral is a major problem. A business built around information technology and located in a rural Virginia community may have few, if any, assets that the local bank considers to be collateral. The small business may not own a building or equipment and machinery. A computer is poor collateral because it loses its market value within two to three years as new technology makes it obsolete.

Borrowing money to grow rural small businesses that will help Virginia's rural communities get off their financial and economic knees has, therefore, been difficult. Many "almost bankable" loans are denied. If small businesses in rural Virginia could borrow and expand, they might contribute more to the overall state economy and help push rural Virginia toward self-sufficiency with a pace of economic activity paralleling the urban sectors of the state. Capital access programs have the potential to bridge the collateral gap.

With the state budget shortfalls, the 2002 General Assembly turned down the recommendation for expanded state deposits in the Virginia Capital Access Program (VCAP). In difficult budget times, talk usually centers on the need for initiatives to be revenue neutral before anything new is approved. The VCAP meets the revenue neutral requirement and differentiates itself from other loan programs by being revenue positive to the state.

Revenue Positive for State Coffers

According to program records in recent years, $1.00 in state money committed to the VCAP has generated $33.00 in new loans. The realized leverage factor of 33:1 has put at least $3.00 to $4.00 in new income and sales taxes into state coffers for each $1.00 of state money in the VCAP reserve fund.

The program looks like a sure winner, but getting something done requires that all involved parties see and understand the unique leveraging ability imbedded in capital access programs. It does not initially seem logical that the state could commit $1.0 million to the VCAP to stimulate new business activity and get back $3.0 million to $4.0 million in new state tax revenues. If the program can truly generate

Wayne D. Purcell is Alumni Distinguished Professor, Department of Agricultural and Applied Economics, Virginia Tech

Horizons (ISSN 1075-9255) is a publication of the Rural Economic Analysis Program (REAP) in the Department of Agricultural and Applied Economics and the College of Agriculture and Life Sciences at Virginia Polytechnic Institute and State University. Please address all correspondence to REAP, Dept. of Ag. and Applied Econ. 0401, Virginia Tech, Blacksburg, VA 24061; phone: (540) 231-9443; email: reap01@vt.edu.

Virginia Tech

such returns, one might ask, "Why not use the VCAP to 'spend our way to prosperity'?" Such a reaction is overly simplistic, however, and fails to recognize the constraints every rural community faces. A limited number of almost bankable loans exist in any rural community. On a scale of 1 to 10 where 1 is no risk and 10 is very high risk, any number of financial institutions will jump at the loans rated 1 to 3. The 7 to 10 high-risk loans will never be extended. The 4 to 6 rated loans are the almost bankable loans to a firm with a good business model that has weak collateral. But in most rural communities, only a limited number of small businesses fit this profile.

A distinguishing feature of capital access programs is that they deposit money in a *reserve fund*. Capital Access Program reserve funds are held in the participating bank. The reserve fund becomes a buffer to the risk of loss the bank faces and encourages the banks to make the almost bankable loans turned down in regular loan programs. Over time, the reserve fund grows, provides a larger buffer against risk of business failure, and supports more Capital Access Program loans.

Within the constraints set by the number of almost bankable loans, it is useful to look in greater detail at the VCAP. Examining the program requires understanding its basic tenets:

1. State money is not loaned directly. The state money goes into the program's reserve funds to encourage bankers, with the banks' existing infrastructure and lending capacity, to make the almost bankable loans that they have been turning down because of inadequate collateral.

2. Banks cannot take advantage of the reserve support coming from state funds and exploit the program by putting all or most loans through the VCAP. The borrower and bank are required to pay a negotiated percentage of the face value of the loan as an up-front fee. State funds then match the borrower/bank deposit. In practice, since the bank usually passes the fee to the borrower, the borrower has a negotiated 3.0 to 4.0 percent of the face value of the loan added to the loan repayment schedule. The state then matches the 3.0 to 4.0 percent with a deposit into the VCAP reserve fund. Borrowers will not pay the 3.0 to 4.0 percent if they can borrow money through other programs without the additional fee.

3. The majority of the loans under the VCAP are made to business firms that cannot get money through traditional programs. The reserve deposits encourage the bank to make the loans, which have been considered too risky. Therefore, almost all the business activity supported by the VCAP loan will be new business activity. An assessment of the Michigan Capital Access Program, the model for the Virginia program, across a 10-year period indicated that 88 percent of the loans would not have been made if the Capital Access Program had not existed (Hamlin).

4. The VCAP picks up where other loan programs would reject potential borrowers. It competes with other bank programs like small business loan programs in only a limited way since borrowers will use loan programs that do not involve the added cost if they can qualify for an alternative program.

How the VCAP Works

An example will help clarify the potential of the VCAP, a potential that is large because of the leveraging involved. The negotiated fee that the borrower has to pay is assumed to be 4.0 percent. That 4.0 percent is matched by state deposits. With a 4.0 percent match requirement, the leverage factor of dollars loaned per $1.00 committed by the state would be 25:1. The VCAP reports, on average, leverage of 33:1 in recent years. Using a 25:1 ratio in the example does two things: (1) it allows for a double match of 8.0 percent by the state on some loan requests, and (2) it helps ensure that any program benefit measures generated are conservative.

If the leveraging is 25:1, $1.0 million in state deposits will support $25 million in new loans. To assess the multiple economic impacts of the new business activity that the $25 million in new loans generates requires that the impact of the $25 million be traced through the entire economic system.

Employment multipliers are either (1) a multiple of the number of new employees in the business firm that borrows the money or (2) the number of new jobs per $1.0 million in new sales revenue. The multiplier showing the number of new jobs per $1.0 million in new sales is widely used in the research literature when the number of dollars in new final sales is available or can be generated.

One way to estimate the new sales that the $25 million in new loans will generate is to analyze the ratio of sales revenue to current liabilities from the balance sheets of a number of business firms active in the Virginia economy. Across 20 business firms examined, the revenue/current liabilities ratio ranged from 3:15:1 to 12.58:1. The average was 6.43:1. To be conservative in estimating new sales, the lowest number (3.15) is used, and the $25 million in new loans results in $78.75 million in new sales (3.15 x $25 million).

Researchers have developed detailed employment multipliers by tracing all the new business activity that develops in input supply firms, transportation services, financial businesses, and so forth, and counting the new jobs created in the borrowing firm and all the related businesses. The number of new employees per $1.0 million in new sales varies depending on the type of economic activity involved. In nine research efforts designed to estimate employment multipliers, numbers range from 24.6 new employees per $1.0 million in new sales up to 54.2. The average was 35.5 new jobs per $1.0 million in new sales. Using the most

Virginia Tech does not discriminate against employees, students, or applicants on the basis of race, color, sex, sexual orientation, disability, age, veteran status, national origin, or political affiliation. Anyone having questions concerning discrimination should contact the Equal Opportunity and Affirmative Action Office.

conservative number of 24.6 new employees per $1.0 million in new sales would generate 1,937 new jobs (24.6 x 78.75).[1]

The calculations to this point are not complicated and are based on verifiable numbers. The 1,937 new jobs could involve hiring people who are moving into the communities, hiring people from a pool of unemployed local residents, or hiring workers who transfer from other employment in the community.

> ***The Miracle of Leveraging***
>
> $1 million in state reserve deposits
> *generates*
> $25 million in Capital Access loans
> *generates*
> $78.75 million in new business sales
> *generates*
> 1,937 or more new jobs
> *generates*
> $2.34 million or more in new state taxes

Following the new economic activity through the system leads to the tax impacts. Assuming a $10.00 per hour job has been created, approximately $22,000 per year in personal income is associated with each new employee. Across the years, the percent of personal income that is paid to the state in income and sales taxes varies. In 2002, total state taxes took 5.5 percent of personal income in Virginia, down slightly from 5.8 percent in 2001 (2002 State Tax Revenue).[2] Multiplying the $22,000 per new employee by 5.5 percent gives $1,210 in state income and sales taxes per new worker. Using the 1,937 new positions created from the $25 million in new loans yields $2.34 million ($1,210 x 1,937) in *new tax revenue* coming to the Commonwealth of Virginia.

The ratio of sales revenue to current liabilities and the employment multiplier used in the calculation were the most conservative estimates available. To reduce the $2.34 million in new tax revenues to $1.0 million so that it only matches the $1.0 million the state has deposited would require employment multipliers so low that it would be virtually impossible to find examples in the research literature. Some reduction in impacts may occur if the new job is created in one year and the income tax is not paid until the next year. It may also take some time to fill the vacated jobs when existing workers in the community move to the new jobs. But such reduced impacts are only time delays. Once the time lags are no longer an issue, there is no continuing drain on state tax revenues.

A Win-Win Opportunity

Overall, the VCAP is a win-win opportunity. The $1.0 million of state money has not been spent. It is still available to leverage new loans. Some states, including North Carolina, are reclaiming some of the excess reserves in the participating banks' reserve accounts as these accounts grow over time. As funds are reclaimed, they are used to expand the Capital Access Program in other banks or to support other state programs.

Banks use their personnel and expertise to lend their own money. In the Commonwealth to date, the paperwork has been minimal. The participating bank fills out a one-page form for each loan it negotiates through the VCAP.

Opportunities now exist in the Commonwealth for any technology company and for banks making their first $1.0 million of loans in the program to receive a double match from the state. Using an 8.0 percent state match reduces the leverage factor compared to a 4.0 percent match. If all loans had a double match from the state, instead of $25.00 loaned per $1.00 of state funds in the program, leverage drops to $12.50 loaned per $1.00 deposited. Even so, the program would still be better than revenue neutral and would generate over $1.0 million ($2.34 million divided by 2.0 or $1.17 million) in new state income and sales tax for each $1.0 million of state money in the program.

Investment opportunities always need to be evaluated with the leveraging potentials in mind. Interested parties, whether they are potential borrowers, interested bankers, or elected state leadership, need to recognize the tremendous opportunities from the leveraging capability of the VCAP. The leveraging benefit of the program is analogous to the leveraged impact of savings or investments extended over a long time period. In a savings account or certificates of deposit (CD's), a 6.0 percent rate of return means the investment will double in 12 years. Time works the miracle of leveraging in the savings account or CD's.

The VCAP requires the same type of scrutiny so that the significant benefits of the leveraging of each dollar are clearly seen. One should not, for example, dismiss the possibilities and say, "It does not make any sense that $1.0 million in state funds would generate $2.34 million in state tax revenue. Nobody will believe those numbers." But that $2.34 million in new tax revenues is exactly what can happen, and the $2.34 million is, by design, a conservative amount at the lower end of the range of new taxes that would be generated. The number of almost bankable loans that would otherwise be turned down in Virginia's rural communities impose limits on VCAP possibilities. Both research and anecdotal evidence show that a significant number of such potential loans exist.

---

[1]See the RVPC Final Report and working papers at *www.rvpc.vt.edu* for more detailed explanations and illustrations on the calculations.
[2]Personal income is defined by Bureau of Economic Analysis as earnings from place of work plus dividends, interest, and rent plus transfer payments, minus social insurance. (US Dept. of Commerce "Documentation," Regional Economic Information System 1969-2000, Bureau of Economic Analysis RCN-0295).

The capital access idea, to borrow from an old adage, is clearly "an idea whose time has come." It fills a need in the modern business economy where collateral is often limited in an information technology or computer-based business. Computer-based small businesses do not require tremendous investments in buildings and infrastructure, are not a threat to the environment or landscape, and are exactly the type of small business that rural communities would like to see develop, grow, and prosper.

More than any other recommendation made during the long deliberations and negotiations of the Rural Virginia Prosperity Commission, expansion of the VCAP emerged as an immediate way to improve the economic position of rural communities. The VCAP deserves additional funding support. An expanded VCAP should be the center piece of any rural community development program in the Commonwealth.

References

2002 State Tax Revenue. Found at *http://www.taxadministration.org/fta/rate/02taxbur.html*. Accessed 27 May 03

Hamlin, Roger. *The Capital Access Program: An Evaluation of Economic Benefits*. The Michigan Strategic Fund, The Michigan Jobs Commission, 1998.

Kruja, Zana, Karen Mundy, and Wayne Purcell. *Is Access to Credit Limiting Diversification and Economic Development in Rural Virginia?* REAP Policy Paper No. 9. VCE Pub 448-309/REAP P009. Oct. 1998.

Rural Virginia Prosperity Commission. *From the Grassroots: Final Report of the Rural Virginia Prosperity Commission to the Governor and the General Assembly of Virginia.* Found at *http:www.rvpc.vt.edu*. Last accessed 10 July 2003.

Virginia Dept. of Business Assistance. Virginia Capital Access Program. Found at http://www.dba.state.va.us/financing/programs/virginia.asp. Last accessed 10 July 2003.

Notices

Please notify the REAP office if your address changes or if you know of anyone who would like to be added to our mailing list.

****How to reach us:** REAP, Department of Agricultural and Applied Economics 0401, Virginia Tech, Blacksburg, VA 24061; by phone: (540) 231-9443; by email: *reap01@vt.edu*; or on the web at *http://www.reap.vt.edu/*

****Farm and Family Showcase:** Kentland Farm, September 4 -6 from 10 -5. Parking is $5.00; no admission fee. Activities for the whole family include exhibits, demonstrations, seminars, play areas, rides. For more information see the website: *http://www.farmandfamily.vt.edu.*

****Second Harvest Food Drive:** Bring *nonperishable* food items to Farm and Family Showcase for distribution to 470 food pantries across Southwest Virginia.

Printed on recycled paper
VT/001/3.5/240366/0703

HORIZONS

Virginia Polytechnic Institute and State University
Department of Agricultural and Applied Economics 0401
Blacksburg, VA 24061

Address Service Requested

Non-Profit Org.
U.S. Postage
PAID
Blacksburg, VA 24060
Permit No. 28