Strengthen local communities

While many communities have flourished in the past few decades, others have faced hard times and struggled to adapt to the realities of a new economy. Many local economies have not fully bounced back from the decline of employment in major industrial sectors like manufacturing. The well-paying, middle-income, middle-skill jobs have slowly faded away. The lack of jobs means less revenue for state and local governments, which in turn leads to cuts in important government sources, such as education. After these cuts, residents leave the state and the process repeats itself.

Instead of succumbing to their current situation, many states have taken proactive steps to help strengthen their communities and boost development in local economies. These programs help small business, spur innovation, boost local lending, improve the efficiency of community investments, and help low-income workers keep more of their money—all helping create the foundation of long-term economic growth. These programs, in conjunction with others detailed in this report, can help many local communities get back on the way to economic prosperity.
Use state policy and assets to drive innovation and entrepreneurship

Background

All too often, states seek to boost economic development by offering ever-increasing tax breaks—but this strategy is unlikely to be a long-term winner for states. At best, this strategy simply encourages businesses to move from elsewhere, and its effectiveness at that is questionable. More problematic: The strategy does not necessarily drive new innovation, which is important for long-run economic development that sustains high-quality jobs or attract the best kind of businesses—“high-road” business owners who obey the law, pay good wages and benefits, and know that their bottom line is better served by locating to areas with a skilled workforce and modern infrastructure, rather than the place that offers the biggest tax break. Moreover, these tax breaks are too often quite costly—eroding the state tax base for little public benefit.

States are better served in the long run by investing in the human capital, infrastructure, partnerships, and culture that can help to catalyze the formation of innovation clusters. This means going beyond luring businesses to a state, but rather seeding the state’s economic soil with new businesses and forward-looking ideas with the potential to grow into new economic opportunities. And when governments do offer financial incentives to companies, they should ensure they offer a good return on their public investment, in the form of good paying jobs, a long-term commitment to remain in the community, and even a share of the profits.

Increasingly, forward-thinking state governments are teaming up with the federal government, local institutions, and even other state governments—when regional economies spill across state lines—to invest in workforce development, economic development, and other programs to boost the competitive edge of our economy.

These investments are being linked to “regional innovation clusters”—groups of diverse public- and private-sector stakeholders that together support innovation in states and regions. State governments are positioned to play a unique convening role in bringing together stakeholders—including existing companies, individual entrepreneurs, venture capitalists, new startup businesses, private and public universities, community colleges, regional economic development organizations, federal facilities, and job centers like ports and airports—to help innovation clusters form and grow.
When states bring together and encourage interaction among the building blocks of these clusters, innovation and economic growth result. Further, these public investments, according to many prominent economists, are linked to higher wages and higher rates of employment. While many states are investing in regional clusters, more can be done to grow local businesses and soften the ground for innovation.

**Invest in technology incubators, accelerators, and regional innovation anchor institutions**

State governments should support those who are already interested in innovation and entrepreneurship through direct financial support—direct grants or seed capital—as well as indirect supports such as counseling, office space, and entrepreneurship guidance.

Ohio, for example, has a public-private initiative called JumpStart, which provides a network of experienced entrepreneurs to provide one-on-one advice to first-timers. The most promising JumpStart clients compete for a limited pool of seed funding. And JumpStart acts as a hub for private-sector investors—connecting them to Ohio startup companies.

Pennsylvania’s Innovation Works and Washington’s Innovate Washington programs similarly provide a combination of counseling, networking, office space, and small pools of grant funding to bridge the gap between research and market, helping young technology companies get off the ground.

Other states invest directly in their own homegrown entrepreneurial talent. The Invest Maryland initiative, for example, is a $70 million investment fund for early-stage technology companies in the state. Companies receiving the funds are required to pay back the state’s investment and provide it with a share of the profits.

Pure Michigan Business Connect uses a network of different funds totaling $2 billion to support small companies, startups, and technology commercialization within the state. And in Virginia the Commonwealth Research Commercialization Fund provides millions to seed-stage companies that are bridging the gap between university research and marketable product.

Connecticut Innovations operates essentially as state-run venture capital firms, but with an explicit focus on fostering high-technology entrepreneurship
activities in Connecticut.12 And the state of Illinois Department of Treasury maintains a Technology Development Account, which invests in private-sector venture capital firms.13

Invest in innovation and commercialization on public university campuses

Universities are hubs of innovation, startup formation, and job creation. The research, science, and technology that flow from them are the major economic anchors of regions, but they are not being leveraged to their fullest potential to spin out new companies, new technologies, or new jobs in regional markets.14

State governments should increase the role their public-university systems play in local innovation. While there is no one right way to encourage university involvement in innovation, promising models are being adopted that:

• Increase investment in high-risk, large-scale, potentially transformative early-stage research (such as Nevada’s Knowledge Fund)

• Promote small-business spinouts and collaboration with cutting edge industries to bridge the gap between the lab and the marketplace (such as Michigan’s University Commercialization Initiative)

• Give faculty credit for patents and commercialization when they are being considered for tenure or promotion (such as the University System of Maryland)15

• Develop better infrastructure for measuring the impact of federally funded university research on human capital, jobs, and markets16

Many states are investing in the innovation that flows directly from university research. The University of Texas at Austin Technology Incubator, for example, provides office space and mentorship to startup companies that take root in university research or on the university campus.17 In Michigan, the Michigan University Commercialization Initiative provides seed funding for promising startups in the state working to commercialize the fruits of federally funded university research.18

Nevada also has two funds managed by the state’s Economic Development Authority that target universities: the Knowledge Fund and the Catalyst Fund
provide funding to universities and businesses, respectively, to develop and pursue business plans for the fruits of publicly funded research.19

Be more strategic about use of exiting state funds to support innovation

Too often government programs supporting entrepreneurs by investing in human capital, workforce skills, infrastructure, and research lack a coordinated vision to work together to drive innovation.

Better coordination of existing programs to support small business—such as regional growth initiatives, research, technology, and workforce-development programs—can help make the most of each of those different efforts. Fortunately, many states have initiated reforms to help increase coordination among these different areas.

Colorado’s Gov. John Hickenlooper (D) signed an executive order asking each county to submit a summary of startup activity within its own borders to the state’s Office of Economic Development and International Trade, the findings of which will help guide statewide decision making about technology, talent, and economic development investments.20

By assessing existing capabilities and developing a strategic innovation vision, states stand to improve their performance measures for job creation and innovation. Going even further, states could combine all statewide funding opportunities for technology, business development, economic development, and workforce training into a single common application, like standard college applications. This would help put decisions about aligning business, technology, and workforce programs in one place where they can better collaborate to promote innovation, while saving applicants time and money.21

Streamline and modernize government services for small businesses and start-ups

States can further help in-state small businesses and startups by streamlining and modernizing government services. Several states have redoubled their efforts to help small business by identifying outdated regulations and duplication, licensing and permitting hurdles, or needless regulatory duplication.
In 2010 Maryland Gov. Martin O’Malley (D) signed an executive order creating a small-business commission charged with identifying permitting, licensing, and regulatory barriers to business success. This led to the creation of Maryland Made Easy, a state effort to streamline application processes and simplify regulation, which has implemented three key policy initiatives:

- **The Central Business Licensing Initiative**: Created a one-stop shopping website to consolidate all state permits and licenses, and submit various applications.

- **Fast Track**: A program to expedite state review of qualifying development projects, which will allow priority projects to receive increased state executive attention.

- **Access Permit Process**: A new process from the State Highway Administration that will make it easier for businesses to obtain permits for development projects.

And in 2010 Washington’s Gov. Christine Gregoire (D) issued Executive Order 10-05, which includes a number of provisions to help small businesses compete on a fair playing field. The order consolidates small-business licensing, registration, and certification guides into one online resource and provides a plan to evaluate current regulatory steps and processes required of small business. It also identifies ways to streamline these processes and procedures without diminishing public health and safety.

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**Spur local lending**

**Background**

In the wake of the Great Recession, small businesses are in a difficult situation. The economy is recovering, but finding a loan to start or grow a small business is difficult. The number of small-business loans has been on the decline since 2008, according to data from the Federal Deposit Insurance Corporation analyzed by the Small Business Administration.

And while small-business loans continue to shrink, loans to large business seem to be picking up, according to research by the Federal Reserve Bank of San Francisco, which also found that lending to small business has declined by more than $47 billion since its peak in 2007.
While the Small Business Administration helps small businesses at the federal level, states can take action to improve credit access for local businesses. Unlike large businesses that can raise money in the stock or bond markets, small businesses are reliant upon bank loans.26 Cheaper, more readily available bank loans would help entrepreneurs start new businesses as well as finance expansions of already existing small businesses. State governments can help increase the flow of capital to local businesses in several ways, including establishing a state bank and creating a “lend local” program.

Establish a state bank

State legislatures should consider establishing a publicly owned state bank to spur local economic activity and facilitate small-business growth. The bank would primarily encourage lending indirectly through participation loans in conjunction with private-sector banks. By participating in these loans, the state bank would drive down the cost of the loan for both the participating bank and the customer and thereby allow for the loaning of more funds.

The main source of liquidity and funding for the bank would be deposits from the state government and all state agencies, which would be required to deposit funds in the state bank.27 While the bank would eventually become self-sufficient, initial seed funding for the bank could come from the state general fund, general obligation bonds, or another dedicated funding source.28

North Dakota has proven the value of such a system with their nearly century old model.29 The Bank of North Dakota—the only state bank in existence in the United States—was created by the state legislature in 1919. The Bank of North Dakota routinely turns a profit and then returns those profits to the state’s general fund. Since 1945, when the bank started transferring profits to the state government, it has given more than $555 million to the general fund.30

Like the North Dakota model, state legislatures could enable the bank to take deposits from other organizations and individuals. The experience of North Dakota shows, however, that these deposits would not be a large portion of its deposits. Only 1.5 percent of the Bank of North Dakota’s total deposits are retail deposits.31 The small share of deposits from individuals should assuage concerns that a state bank would siphon deposits away from private retail banks.
Finally, legislatures should ensure that such a bank would be run by a professional, nonpolitical staff—such as other commercial banks—and be overseen by a board of directors appointed by the governor and chaired by the state treasurer.

According to the National Council of State Legislatures, there were 19 bills pending in 14 states as of May 2012 that would either call for study of the issue or create a state bank.32

Create a banking partnership program for local businesses

States can also encourage private banks to lend to local, small businesses through “lend local” programs that provide dollar-for-dollar matches on all applicable loans with state funds deposited in the bank.33 This reduces the risk of the loan to the bank because it knows an equal amount of funds are in its reserves. Participating banks would be required to pledge that the loans would go to local, small businesses, and the state would provide an oversight role to ensure that this happens.

In 2011 Massachusetts adopted this model through the creation of the Small Business Banking Partnership, which encourages loans to small businesses by moving state funds to community banks. Massachusetts originally intended to only deposit $100 million, but the program was so popular that the initial amount was expanded and as of July 2012 the program had resulted in more than one-quarter billion dollars being moved to community banks.34

In order to participate, banks must disclose their lending activity every quarter on their own website and the Massachusetts Treasury website.35 Qualifying banks are also required to disclose their previous small-business lending practices to the state before entering the program, allowing the state to ascertain if the bank is seeking out new, higher-risk loans and prevent banks from receiving state assistance on loans they would have made anyway.36

Maryland and Oregon adopted similar programs in 2012. The Maryland law37—which is not yet been implemented—will require that the interest rate charged to the small business be two percentage points below the going rate. Oregon has taken a slightly different approach in which the state runs a fund that lends money to local banks, in addition to making loan guarantees for local and community banks.38 Some activists have raised concerns that the fund will be too focused on
venture capital investments, which will be bought by out-of-state companies and neglect assistance to lending to local businesses.39

Use social impact bonds to improve outcomes

Background

Social impact bonds are an innovative new form of funding social-service programs that pays for what actually works. The Center for American Progress has been a leader in exploring the policy implications of social impact bonds over the past several years.40 State governments should begin to experiment with these programs while ensuring that they do not drive down government standards, including job standards for program workers.

Governments usually pay upfront for services to be completed, not for the actual outcome of the services. Too often, this method results in overly prescriptive guidelines that prevent the use or development of more effective delivery models over legacy programs. Furthermore, paying for outcomes allows the government to experiment with delivery models that have already proven successful in the philanthropic sector.

The social impact bond model instead pays depending upon the outcome of the service. More precisely, the government sets an outcome they want achieved relative to a specific population and contracts with an external organization that pledges to achieve that outcome. The external organization hires and supervises service providers who perform interventions intended to achieve the outcome. But the government only releases funds once the outcome has been achieved. For working capital, the external organization raises money from private investors to fund the interventions. If the programs are successful, the government releases an agreed-upon amount of money and the private investors receive a return on their investment. The model contains no direct relationship between the service provider and the government. Social impact bonds are an attractive investment for the private sector not only because they offer financial returns: Increasing interest in “impact investing” has many investors pursuing so-called “double bottom line” investments, which can result in both financial and social returns.
The model has been implemented in the United Kingdom and several state and local governments have started on the path to using social impact bonds. New York City has announced the first social impact bond in the United States to support a criminal justice program, while Massachusetts is negotiating two bond agreements and Connecticut and New York state are strongly considering the option. These financing instruments can help expand government services, particularly preventive services, as well as help develop best practices that can be incorporated into traditionally funded service provision.

**Ensure state budgets can allow for proper use of social impact bonds**

States should amend their budgets so they can allow multiyear payments for social impact bonds and ensure unspent funds will revert to a designated program instead of the state general fund.

The very structure of social impact bond agreements may not be compatible with current state budgeting practices. State budgets mostly operate on a one-year schedule, though several states have biannual budgets. Social impact bonds, however, require that payment for an ongoing service be delayed for several years, until the outcome is achieved. Governments are not used to making such delayed payments and should ensure that their budget rules allow for these sort of payments. States could alleviate this problem by allowing their budgets to delay payments and holding the funding in reserve until payment is due in accordance with social impact bond agreements.

Conversely, the external organization in a social impact bond agreement may not achieve the agreed-upon goals, meaning the government will not make a payment. This would result in the government having “leftover” funds. In many states, these unspent funds will revert directly to the state’s general fund instead of returning to the budget line for which the funds were originally intended. States can rectify this problem by writing into the statute that unspent funds return to a specific budget or by creating a trust fund to hold social impact bond outcome payments.

**Guarantee that payments will actually be made upon success**

States should assuage the concerns of external parties by extending the full faith and credit of the state to social impact bond outcome payments.
Due to concerns about politics and the short-term budgeting practices of state governments, external parties might be worried that they won’t receive payment when a social impact bond project is complete. In a normal government-contracting situation, the provider would receive payment as the services transpired, not in a lump sum at the completion of the project. This deferred payment system creates uncertainty for external parties.

That uncertainty would be mitigated if the state guaranteed the payment, contingent upon completion of goals, with the full faith and credit of the state government. If the state reneged on the agreement, the state government’s credit rating and ability to raise funds would be impaired. Actual risk to the state, however, would be quite low for state governments that follow the state budgeting practices recommended above.

Massachusetts included this provision in appropriations legislation dealing with its social impact bond program. 44

Ensure state is not directly contracting with the service providers, while upholding high standards

States need to ensure that there is an arms-length relationship between the state government and the service provider while ensuring that they do not drive down government standards, including job standards for program workers.

One of the key aspects of the social impact bond’s agreement is that service providers are chosen by external organization, not the state government. This allows the external organization to find the best possible service provider to achieve the outcome without being beholden to political considerations or legacy programs. But in order to ensure that social impact bonds do not drive down job standards, governments should consider how to apply high standards for government contracting (detailed on page 13) to service providers.

In the original social impact bond programs in the United Kingdom, which serves as the model for U.S. states, the external organization had considerable freedom to choose service providers. 45 Massachusetts conducted a procurement to select service providers for its social impact bond deals independently of its selection of external organizations. 46 States that use social impact bonds in the future should be cautious if they make this choice. If the state chooses the service providers an
external organization is to work with, the external organization may have grounds to claim that they are not responsible should the social impact bond agreement fail to achieve the specified outcome.

Protect residents from predatory lending and unfair financial practices

Background

Millions of working families across the United States struggle to pay bills and balance their family budget every month. And this struggle has been even more difficult during the economic downturn for large number of families with a wage-earner unemployed.

Short-term loans—such as those offered by payday lenders, auto-title loan companies, and rent-to-own contracts—promise struggling Americans access to the needed funds or assets to provide for their families. And for the unbanked, often the only way to access the money they earn is by paying high check-cashing fees.

The total cost of interest and fees charged in total by these practices weighs working families down with debt that is hard to escape. Payday lenders routinely charge a 400 percent annual percentage rate, for example. And it is estimated that 76 percent of payday loans are “churned”—meaning borrowers repeatedly take out payday loans to pay off previous loans—with the fees from churning netting lenders $3.5 billion annually, according to a 2009 study by the Center for Responsible Lending.47

Moreover, paying off this debt and fees creates a cycle where families cannot build the savings they need to withstand even a minor financial emergency, which is a particular concern since far too many Americans are financially fragile. Nationwide, 27 percent of households do not have sufficient net worth to subsist at the poverty level for three months in the absence of income.48 And when a recent paper for the National Bureau for Economic Research asked American survey respondents in 2009 if they would be able to come up with $2,000 in 30 days, only about half of all households reported being “certainly able” or “probably able” to come up with the amount.49

The policies below will help protect residents from extremely unfair lending practices, prevent this cycle of debt, and promote savings for middle-class Americans.
Ban payday lending

State legislatures should ban payday lending. Payday lenders provide short-term loans that usually span only a few days or weeks—but turn a profit by charging extremely high interest rates.

In order to receive a payday loan, a borrower will write a check to the lender for the amount borrowed plus an additional fee. The lender keeps the check until the borrower returns later with a check, usually a paycheck, for the full amount, or the borrower can roll over the loan for an additional fee. In order to access these short-term loans, borrowers are charged rates astronomically higher than other consumer-finance products. One study found that the annual percentage rate on these loans range from 378 percent to 780 percent. 50

As of 2012, 14 states have prohibited payday lending. 51 To do this, states require payday lenders to keep their rates and fees below the rate cap for other lenders in the state. Because the business model for payday lenders requires extremely high rates, the practice is effectively banned. Many states place some other limits on payday lenders, but the most effective route is to ban the practice altogether.

The recent experience of Arizona and Ohio show the popular support for eliminating payday lending. In 2000 Arizona passed a law exempting payday loans from the state’s 36 percent interest rate cap on consumer loans with the provision that payday lenders would be subject to the cap again in 2010 unless a more permanent action was taken. In 2008 the payday-lending industry attempted to extend the exemption indefinitely through a ballot initiative to legalize payday lending. 52 The initiative, however, was defeated by a wide margin and the ban was reinstated in 2010. 53

Similarly, Ohio passed legislation subjecting payday lenders to a maximum interest rate of 28 percent. The law, supported by four former governors, survived a ballot initiative in 2008. 54 While lenders in the state have been aggressively fighting the rule, the public support for banning payday lenders is quite strong.

In Ohio’s case, however, lenders have been able to find loopholes in the law by using different types of business licenses. State laws must be matched with enforcement support from state attorneys general as well as state banking and licensing agencies.
Ban auto-title loans

Auto-title loans are a similar short-term predatory lending scheme whereby loans are secured by signing over the title of the borrower’s automobile, and in some states handing over a set of keys. If the borrower fails to pay back a loan, the lender can take and sell the car.

The Corporation for Enterprise Development recommends that states should enact laws that either ban car-title lending entirely or institute a cap on interest and fees with an annual percentage rate of 36 percent. Significantly more states—31 in total—have outlawed high-cost car-title loans, either through outright bans or interest-rate caps, than have banned payday lending.

Cap check-cashing fees

Americans without bank accounts are encountering more expensive fees as they cash checks at check-cashing centers rather than at banks. Between 1997 and 2006, the average cost to cash a paycheck rose by 75.6 percent, so that the average blue-collar worker cashing a paycheck in 2006 was charged $19.66 for a $478.41 check, according to the Consumer Federation of America—more than 4 percent of the worker’s income gone just to cash the check.

State legislatures should protect the unbanked by capping check-cashing fees to modest amounts. The American Association of Retired Persons, or AARP, has created a model state statute which ensures that no check-cashing location may charge more than 1 percent or $5, whichever is less, for the cashing of a check that is either a payroll check or a government check, and grants the consumer a private right of action to sue for any fraud.

So far 24 states have passed laws to cap check-cashing fees. New York, for example, caps the amount that can be charged on cashing checks at 1.91 percent of the face value.

Treat rent-to-own contracts as credit transactions

Rent-to-own contracts should be treated as credit transactions and regulated as such, subjecting them to interest-rate caps and truth-in-lending requirements.
Stores with rent-to-own programs allow customers to take possession of good in return for regular payments over a period of time. The stores claim that customers are essentially renting out goods for a short period of time. A customer, for example, might want to rent a large screen television to watch a big football game with friends. But in reality, the large majority of customers actually intend to buy the good at the end of the rental period. According to the Federal Trade Commission, 90 percent of merchandise that customers made substantial contributions toward were purchased and only 10 percent were returned. So instead of serving as a rental service, the company essentially has provided a loan to the consumer. And for the most part, the final cost of rent-to-own goods is much higher than the cash price.

Forty-seven states regulate the rent-to-own industry, with the majority of the regulations being very similar. These laws require contract disclosures, restrictions in fees, and disclosures of in-store fees.

Only a few states recognize rent-to-own sales as credit transactions. Courts in states including Wisconsin, Minnesota, and New Jersey have ruled that rent-to-own transactions are credit sales and can be regulated under state laws governing credit sales. New Jersey regulates the transactions and subjects them to an interest-rate cap.

Vermont does not consider rent-to-own a credit transaction, but it does require the disclosure of effective interest rates.

**Require an opt-in for sharing of private financial information**

States should require financial firms to receive an affirmative response from a customer before they share private information with a third party.

Financial institutions are currently allowed to share and even sell private information about an individual to other institutions, such as retailers, airlines, and telemarketers. This information can include what you have purchased recently, how much you’ve borrowed, and whether you pay back your loans on time. Financial institutions are required to disclose the information to customers and allow them to opt-out of the information sharing. This process, however, puts the burden on the customer to protect her or his privacy.

Requiring the financial institution to get confirmation from the customer that they can share information would function as an opt-in option. The burden would
therefore be shifted onto the financial institution. Furthermore, customers would be more aware of and have more control over their private information when faced with having to consent to the sharing of information.

California was the first state to require an opt-in provision for the sharing of private financial information, and 22 states have now enacted these provisions. While opponents of the California law challenged it in federal court, the 9th Circuit Court upheld the law and the Supreme Court declined to review it.
Endnotes


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64 Marceline White and Franz Schneiderman, “Rent to Own: Profiting from the Poor” (Baltimore: Maryland Consumer Rights Coalition, 2012).


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