August 19, 2011

To: REGION FIVE SUSTAINABILITY PROJECT
Economic Development Work Group
Jean Coleman

From: WILLIAM MITCHELL COMMUNITY DEVELOPMENT CLINIC
Holly Hinman, Certified Student Attorney
Caroline Devany, CURA / NPCR Intern, Macalester College
Diane Marie Dube, Supervising Attorney

This memorandum discusses micro-finance as an economic development tool and how the Region Five Sustainability Project could use this tool to promote local entrepreneurs and further HUD's sustainability principles.

This memorandum first puts this tool into context with a discussion of the structural shifts in rural economies and an exploration of entrepreneurship as a community economic development strategy. Identification of barriers to successful entrepreneurial creation in rural areas and a description of some successful applications of rural entrepreneurship development provide the context for a section on best practices for building entrepreneurial depth and breadth in rural areas and the role micro-finance plays in this endeavor. This memo concludes with a discussion of the ways entrepreneurship relates to HUD's sustainability principles and some suggested next steps for the Economic Development Work Group to consider.

Definitions Used in this Memo

Clusters: Geographic concentrations of interconnected companies and institutions in a particular field. Clusters are identified by comparatively measuring the ratio of employment or companies in a specific industry within a region to a computed national average. (Pascal & Stewart, 2008)

Enterprise: An entrepreneurial business or company. (Jones, 2004)

Entrepreneurship: A process through which individuals identify opportunities, allocate resources, and create value. Value is created through the identification of unmet needs or through the identification of opportunities for change. (Emery et. al, 2004)

Entrepreneurial Communities: Communities that recognize entrepreneurship as a potential revitalization agent and intentionally promote a climate conducive to cultivating local entrepreneurs. (Land Policy Institute)

Microenterprise: In the United States, the definition of small businesses encompasses enterprises with up to 500 employees. The term "microenterprise" is used to describe any business employing five or fewer people. (Servon, 2006)

Microfinance: The provision of small-scale financial services to clients whose needs are unmet by conventional banking services and products. (Jones, 2004)

Sustainable Development: Development that meets the needs of the present without compromising the ability of future generations to meet their own needs. (United Nations)

Structural Shifts in the Rural Economy

With the rapid expansion of global trade, technological advancement, and dramatic demographic shifts, many rural geographies are experiencing both a significant decline in traditional resource based industries and population. (Harrter, 2011) Since World War II, the rural population has declined more than 42%. (Drabenstott, 2001) While some rural communities have been able to leverage the presence of natural amenities and/or relative location to a metropolitan area to re-stimulate development, the majority of rural America faces the mounting challenge of economic restructuring and reinvention. (*Ibid*)

Many rural communities have attempted to meet this challenge with the strategy of targeting and attracting outside large-scale industry into their region. This strategy has been largely unsuccessful and continues to become less viable over time as U.S. companies choose to outsource services and production to other countries. Although in some cases economic development controlled by external stakeholders may provide an initial degree of economic relief, it consistently fosters an unsustainable and disempowered community. More recently, in planning for a more sustainable rural America, practitioners have realized the potential role that entrepreneurial development could play in building more stable and vibrant communities from the bottom up. (Emery et al., 2004)

Entrepreneurship as a Community Economic Development Strategy

Entrepreneurship & Small Business in the U.S. Economy Today

Until recently, the influence of entrepreneur-based enterprise on the United States economy has gone relatively unacknowledged. Small businesses created by entrepreneurs play a large role in the United States economy today. It is estimated that companies with 20 or fewer employees account for 86% of enterprise in the United States and that these businesses create about two thirds of the net new jobs in the American economy. (Emery et al, 2004) These small businesses have the potential to grow in scale, and often do. Most successful large-scale companies in the United States have roots as small entrepreneur-based projects. According to the Small Business Administration, almost 70% of the 500 fastest growing firms identified by Magazine Inc started with less than $50,000 in capital. The rate of small businesses formation has increased significantly in recent years. Between 1997 and 2007, the number of microenterprises in the United States increased by 34.35%. (Contreras & Rupasingha, 2010) In response to the large amount of microenterprise and entrepreneurial growth in the economy, the development of entrepreneurial communities has recently been identified and prioritized as a potential community economic development mechanism.

Entrepreneurship as a Community Economic Development Tool

Of significance is entrepreneurship's simultaneous ability to create financial stability for both individuals and communities. (Servon et al., 2010, Emery et al., 2004) Entrepreneurship has been shown provide viable livelihood options to individuals and their families. A recent study conducted by the Aspen Institute found that 53% of the participants in a five-year study were able to lift themselves above the poverty level. (Edgcomb, 2008) The same study found that over a span of five years, the average household assets of low-income entrepreneurs increased by $15,909. (Dabson et al., 2003) For many, self-employment is a more financially lucrative option than wage-based employment. The U.S. Department of Labor has collected data that suggests the earnings of entrepreneurs are over 30% higher than the earnings of a wage laborer. (Henderson, 2002) These economic benefits often extend beyond the individual and contribute to community economic vitality.

The connection between entrepreneurship and economic growth was first credited to economist, Joseph Schumpeter. Schumpeter's theory of creative destruction articulated that by way of innovation, entrepreneurs destroyed old markets and products while simultaneously developing new ones. (Emery et al., 2004) In many cases the innovation and competition fostered by entrepreneurialism serves to create new niche economies within communities and regions. This growth has the power to increase economic vitality and quality of life within a community. Concentrated entrepreneurship ultimately provides local communities a chance to participate and compete in an increasingly global community. (Dabson et al., 2003)

Potential Barriers for Entrepreneurs

Several barriers have been acknowledged within the literature to impede the success of entrepreneurial creation in the United States. Regions seeking to cultivate entrepreneurship on a community-wide scale must cultivate an intentional climate conducive to supporting entrepreneurial activity to address these barriers:

Information Gap/ Technical Support: The complex and formal nature of the United States economy greatly inhibits entrepreneurs' ability to start a business without outside technical assistance. (Appalachian Regional Commission, 2004) Most entrepreneurs need intensive information and technical support for a successful start-up and this can be financially demanding. Even when these services are available, it seems that there are large informational network gaps. In a recent study of microbusinesses in greater Minnesota, the Institute for Rural Policy and Development found that while 80% of small businesses indicated that they would be interested in an information and assistance program, less than half of them had pursued involvement in these programs and almost a third were unsure if such programs existed in their region. (Center for Rural Policy and Development, 2007)

Access to Capital: Capital is a necessary input to start up and maintain enterprises. Unfortunately, would-be entrepreneurs are often unable to access necessary capital. In many cases, conventional banks are not willing to make small loans because the loans are less profitable or borrowers do not meet underwriting standards. Entrepreneurs commonly lack the necessary assets to obtain a loan from a conventional bank. Assets typically used to obtain a loan consist of equity in a home, a positive credit history and previous informal loans from friends and family. Because many believe that the 2008 financial crisis was created by loans to disadvantaged groups, it has become more difficult in the current economic climate for entrepreneurs to access credit products without existing assets. (Servon et al., 2010)

Rural Specific Application of Entrepreneurship Development

Entrepreneurship creation as a development strategy is specifically appropriate considering the challenges that rural America faces. Entrepreneurship provides a realistic employment option in communities experiencing an increasingly dwindling job supply. Generally entrepreneurial jobs are more financially advantageous than other local alternatives. In 2001 self-employed rural workers reported an average income of $33,000 whereas rural private and government employees reported incomes of $27,000 and $30,000 respectively. (Henderson, 2002) Entrepreneurship is also specifically appropriate to the rural demographic challenges of trying to retain the younger generations while providing support for the aging population.

(Edgcomb, 2008) Self-employment both accommodates this older demographic and is attractive to young people. Innovation created through concentrated entrepreneurship not only allows community members to stay in their communities, but also supports the opportunity to build and reinvent them. (Peter & John, 2004) Schumpeter's theory, as corroborated by multiple case studies, suggests that concentrated entrepreneurship has the potential to help re-infuse rural economies and reinvent them as vibrant spaces on the community's own terms. (Edgecomb 2008)

Community-based entrepreneurial development is significant in its sustainability. In contrast to other strategies, it prioritizes holistic development over stand-alone economic growth. A comparative study that looked at rural communities focused on attracting industry and those focused on growing local businesses found that communities which attracted outside development experienced economic growth but no increases in the quality of life. (Renski, 2009) It is not uncommon for rural communities seeking to attract outside industry to engage in what development practitioners have termed a "race to the bottom", in which communities compromise regulatory standards that uphold quality of life to create a beneficial climate for industry. (Emery et al., 2004) In Littleton, Colorado, the strategy of promoting entrepreneurship and local enterprise was coined "economic gardening" (in contrast they labeled industry targeting as "hunting") to emphasize the degree of community control and dependability offered by this strategy.. (Gibbons, 2010) Although "growing" a local economy does not yield instantaneous results, it promotes stability because it builds on pre-existing community assets. (Lyons, 2002) It is far more likely that capital will remain in local circulation and that businesses will be grounded in the community. There is a significant degree of reciprocity of investment and pride shared between the community and its entrepreneurs.

Case Studies

Although at this point the literature is unable to offer conclusive insights on cultivating entrepreneurship as a development strategy, a diverse range of case studies provides some encouraging evidence.

The Community Kitchen Incubator, Athens County, Ohio: Like many other rural jurisdictions, Athens County has experienced a significant loss of jobs due to structural changes in the economy. During the 1990s, the county lost over 1,000 jobs with the decline of several major industries. In response, the region initiated an agenda to advance entrepreneurship that ultimately resulted in a regional innovation economy. Through these intentional efforts, a specialty food sector emerged as a foundation for economic development in the region.

In response to a group of farmers interested in turning their produce into added-value products but were barred by start-up costs, a regional non-profit, the Appalachian Center for Economic Networks (ACEnet) established a tri-county kitchen incubator. By joining the incubator, entrepreneurs not only have access to a space to process their products, but also benefit from an economy of scale operation. ACEnet provides members of the incubator long-term business training and assistance and product development expertise. The strong networks forged from the incubator have fostered a strong culture of innovation. Significant cluster infrastructure, such as food festivals, a buy local campaign, and a regional brand have since been established. It is estimated that the incubator serves around 200 entrepreneurs each year. (Holley)

The kitchen incubator enables benefits that extend to the greater community as well. Pasta Fresca, one of the incubator's tenants, is able to employ low-income women and exchange services with another pasta company located two counties away. Another tenant, Frog Ranch

Foods, was eventually able to purchase two abandoned buildings and convert them into storage space. (Morris)

The community kitchen incubator provides an example of many of the best practices identified in the literature. ACEnet played the role of an anchor institution, a resource that community members were able to identify to help realize an entrepreneurial vision. The creation of the incubator was valuable both because it provided the physical infrastructure for entrepreneurs to create value-added products and because it acted as an inter-regional network (as exemplified by the facilitation of the relationship between two pasta companies). Additionally, as the entrepreneurs regularly congregated in a physical space, they were able to access frequent and diverse technical training.

Hometown Competitiveness Initiative, Valley County, Nebraska: Another successful example in which entrepreneurship was used as community economic development strategy is the Home Town Competitiveness (HTC) initiative launched in Valley County Nebraska. HTC is a larger national program that seeks to serve rural counties experiencing economic distress and extreme depopulation. The HTC initiative strategy promotes entrepreneurialism in Valley County through the creation of a community endowment used to finance entrepreneurs, the promotion of intergenerational transfers of small businesses and assistance to local small businesses to expand through establishment of a larger market than the direct community. Using these strategies HTC helped create 73 new businesses, 332 new full time jobs and increased the per capita income by 22 percent within Valley County.

One specific success catalyzed with HTC assistance was the expansion of a local drug store’s market to include eldercare facilities several counties away and eventually expansion to a national market of eldercare facilities. (Edgcomb 2008, Hometown Competitiveness 2003)

This case study embodies a best practice in promoting access to capital. The fund that HTC helped establish was completely community-based, providing the community with the autonomy and the incentive to invest in local business. HTC also helped create crucial intergenerational connections within the community by promoting the succession of entrepreneurial business to the younger generation. The growth of the local drugstore's market speaks to the power that climate has over the ability of a microenterprise to grow in depth.

Pella Corporation, Pella, Iowa: Pella Corporation, one of the world's largest window manufacturers, provides an example of a high growth entrepreneurship in a rural community. The company was able to initially distinguish itself and cultivate a larger market by providing innovative products. The company continues to pride itself on and prioritize the creation of highly innovative products. (The Pella Story) Despite its extreme growth, the company remains in Pella, Iowa, a community of just over 10,000 people, and is deeply committed to its community. Pella Corporation has consistently made Fortune's list of 100 best companies to work for, a large part of which seems to relate to its hometown origins. (Henderson, 2002) The company is known for its community stewardship within Pella, Iowa. In 2011 the corporation won the Governors Environmental Excellence Award for its annual electronic recycling event. (The Chronicle, 2011) Pella Corporation also created a charitable trust focused on local higher education to benefit employees' families.. (Henderson 2002)

Although high growth entrepreneurship on this scale have been less common in rural communities, the case of the Pella Corporation speaks to the potential that these businesses could play in transforming a rural economy. The company provides an excellent example of the commitment that local entrepreneurs often feel toward their community. Conversely, some argue that the scale of the Pella Corporation has inhibited other entrepreneurs from starting businesses in the area. (Swibel 2005) This identified caveat serves as a reminder of the importance of cultivating a diverse entrepreneurial stock.

Green Business Habitat, Western North Carolina: The Green Business Habitat is an effort spearheaded by the Advantage West Economic Development Group to promote the creation of green technologies and business in Western North Carolina. The initiative emphasizes the use of previously existing assets, such as a strong creative class and natural environment, to create a culture of economic innovation. Advantage West focuses on cultivating several green industry clusters including: clean energy and vehicles, green building technology, natural products, outdoor industry, and climate and environmental technology. The Advantage West Economic Development group's role involves connecting entrepreneurs with capital and facilitating networks for green entrepreneurs through an online forum. The organization has estimated that 1,921 new green industry jobs have been created in the twenty-three county territory it serves, in 2010 alone. (Green Business Habitat)

The Green Business Habitat is a successful example of the potential synergy between entrepreneurship and cluster-based development strategies in rural communities. Having an industry cluster has given entrepreneurs a framework that encourages growth beyond lifestyle-based entrepreneurship. The effort also represents a best practice in combining traditional knowledge with new technologies and paradigms to create economic innovation.

Highland Craftsmen, an emerging enterprise in the area, serves as an example. The company was created by two local residents as an alternative to the construction of generic and unsustainable housing within the community. Highland Craftsmen revived an old North Carolina tradition of creating roof shingles out of bark. The bark is not only a sustainable product, but is also effective in evoking a sense of place. Due to recent interest in sustainability, Highland Craftsmen's shingles have become a popular product in the growing green building industry. (Stanz, 2011) Not only does the fusion of heritage of place and new knowledge create economic innovation, it is a great way to appeal and attract younger generations: Western North Carolina has been able to retain and attract increasing numbers of young people.

Policy has played an important role in enabling the creation of an entrepreneurial community. Two examples include Western North Carolina's creation of a supportive financial climate for green industry and a regulation requiring a community college to be within thirty minutes of every resident. The clusters have become a stable and vibrant enough core to not only grow local business, but to also attract green business from around the country.

Northern Initiatives, Michigan's upper peninsula: Starting in the 1980's, many of the mining operations that had been a source of financial means in the Upper Peninsula began to shut down, exacerbating unemployment rates to near 20%. In response, the region and Northern Michigan University partnered with Chicago's Shore Bank to promote entrepreneurship through creation of a non-profit Northern Initiatives (NI). Today NI has become a formalized community development financial institution, which provides local entrepreneurs with financial products and business consulting and offers communities K- 12 entrepreneurial education. The organization has made 530 loans totaling over $29 million to local business. Within its first ten years of existence, the organization had formed partnerships with 20 banks and derived over $45 million in lending capital from these relationship. The organization provides consulting services to an estimated 200 companies annually.

One specific client that NI has been extremely successful in assisting is Jaquart Fabric Products. With assistance from NI, Jaquart Fabric was able to identify two new niche markets: custom pet beds and a reproduction of the previously discontinued "Stormy Kromer" wool cap.

On the brink of bankruptcy before working with NI, the organization is now a multi million-dollar company employing around 200 local community members. (Markley & Dabson, 2010)

Having an anchor institution within Upper Peninsula has been crucial to promoting creation of an entrepreneurial community culture. The region has since developed a wide range of entrepreneurial enterprises and initiatives. One of the most impressive innovations is the use of once productive mines by several emerging biotechnology companies that focus on the refinement of plant-based proteins. These mines provide growing conditions free of contamination. Michigan's Upper Peninsula's focus on developing entrepreneurship has resulted in increased regional stability and security. (West, 2005) In 2007, the Upper Peninsula had higher employment rates than the rest of the state. (Markley & Dabson, 2010)

Tapetes de Lana Weaving- Mora, NM: Using a $20,000 loan from a non-profit, community member Carla Gomez started a small scale weaving business, Tapetes de Lana, in one of the poorest regions of New Mexico. Gomez initially used an old one-room schoolhouse as a retail and studio space. The business grew and Gomez was able purchase a large vacant building with a grant from the U.S.D.A. With this expansion, Tapetes de Lana began provide a welfare work program for community members. The organization has trained over 100 weavers and regularly employs around 30. (Fisher, 2008) The company has established itself in an increasingly globalized market through developing specialized expertise, such the processing of alpaca wool. The organization has catalyzed a large amount of revitalization in its region, Mora. Tapetes de Lana played a large role transforming the landscape of Mora, establishing what is now the largest wool mill in New Mexico and building a downtown community art center. Benefits have trickled down to related industries, such as local sheep farming. (Gomez, 2005)

Tapetes de Lana ultimately provides a powerful example of the possibility of high growth entrepreneurship rooted in traditional knowledge. This is increasingly common, as communities are realizing that traditional arts and crafts offer a competitive advantage. The case of Tapetes de Lana is also a reminder of the impact that one entrepreneur can have in a community. The organization was able to unintentionally develop a regional cluster and catalyze revitalization of downtown.

Best Practices

Although studies have shown a clear link between entrepreneurship and economic growth, success in creating rural entrepreneurial communities remains inconsistent. The literature largely remains ambiguous in conclusions of effectiveness. A significant portion of this gap can be explained by the relative youth and importance of local context to the development paradigm. Still, it is clear that there are challenges and barriers specific to rural America in developing an entrepreneurial community.

Measuring entrepreneurship within a community is done by looking at breadth (the amount of entrepreneurial activity) and depth (the quality and potential for growth). Breadth and depth correlate with two commonly distinguished entrepreneurial forms: lifestyle entrepreneurship and high growth entrepreneurship. (Henderson, 2005)

> **Lifestyle** entrepreneurs typically operate on a smaller scale and choose entrepreneurship to pursue a lifestyle, earn a livelihood, or live in a particular community. Lifestyle entrepreneurs are often a source of breadth.
>
> **High Growth** entrepreneurs aim to grow larger scale enterprise for the purpose of accumulating wealth. These entrepreneurs are crucial to increasing entrepreneurial depth as there is incentive and direction for growth. (Cheng, 2009)

At this point rural communities have had relatively limited success in cultivating high growth entrepreneurs but are consistently successful at producing lifestyle entrepreneurs.

(Henderson, 2002) The average rural entrepreneurial business creates 1.5 jobs and around 90% of rural service oriented entrepreneurs employ fewer than ten people. (*Ibid)* Rural communities' disadvantage in producing high growth entrepreneurs is perceived as a threat to the potential power that entrepreneurship holds as an economic development tool. (Dabson et al., 2003)

Although high growth entrepreneurs are in many ways more directly linked to community economic growth, it is important recognize the value that lifestyle entrepreneurs are able contribute to communities with microbusinesses. These businesses have the capability to improve the quality of life and sense of place in communities. This heightened sense of place is much of what our culture romanticizes about rural America. (Henderson, 2002) Consequently, building unique rural communities is crucial in maintaining and attracting the population necessary to creating increased economic opportunity. Lifestyle-based microenterprises have the potential to expand with the right support. It is estimated that about 1 in 20 microenterprises will become a fast-growing driver of the economy. (*Ibid*)

The ability to achieve entrepreneurial depth is largely inhibited by the relatively small market size and the remoteness of many rural communities. (Henderson, 2005) In response, practitioners have acknowledged the need to further focus limited resources in capital, workforce development, and infrastructure planning. It has been proposed that the development of regional industry clusters encourage precision in the use of these resources and ultimately encourages high growth entrepreneurship. (Munnich et al. 2002) Clusters -- the concentration of interconnected enterprises -- allow for the development of a regional competitive advantage crucial to success of high growth entrepreneurs. Enterprises in a cluster are able to share access to specialized inputs and information. This sharing and competition of interconnected industry allows for increased innovation, creation of something new or unusual that initiates change in the competitiveness of the market. (Pascal & Stewart, 2008) Many rural communities have avoided pursuing cluster development, believing that an industry cluster requires expertise and knowledge not indigenous to the community. (Lyons, 2002) But there is significant potential for rural communities to develop clusters based on more traditional knowledge. Clusters must build off pre-existing community assets. (Rosenfeld, 2004) In many cases the development of a cluster is an effective way to marry traditional community knowledge with technology-based knowledge to produce an economy of innovation. (Green Business Habitat) The State and Local Policy Program at the Humphrey Institute, University of Minnesota, has conducted many industry cluster studies in Minnesota. For more information go to http://www.hhh.umn.edu/centers/slp/economic_development/industry_cluster_studies.html

In addition to the idea of complimenting entrepreneurship with developing regional industry clusters, other best practices have been identified to further promote a climate conducive to building both entrepreneurial depth and breadth in rural jurisdictions. (Dabson et al., 2003, Servon, 2006, Christy, 2000)

***Access to Training and Technical Assistance*:** Due to the information barrier rooted in technical complexity and the financial sophistication of the U.S. economy, many entrepreneurs require a large amount of issue-specific and technological training to create and sustain their enterprise. It is crucial that a community offer educational resources and opportunities to its entrepreneurial base.

***Access to Capital*:** A recent study conducted by the USDA found that rural markets face a larger challenge in accessing capital than their urban counterparts. In order to create a climate conducive to encouraging business creation, it is imperative that there are a variety of institutions offering a variety of credit products to the microentrepreneur.

***Supportive Culture*:** Creating a community that is supportive of entrepreneurship is crucial to creating a climate hospitable to entrepreneurs. In order to create and support homegrown enterprise, the community must value entrepreneurship as an occupation. An entrepreneur-friendly culture encourages reciprocal investment between communities and their entrepreneurs, leading to longer-term economic stimulation and higher quality of life. In an effort to build an entrepreneurial culture, many rural communities have integrated entrepreneurship into local educational curriculums.

Local Networks: Ensuring that there are organized groups that allow entrepreneurs to share and access knowledge, capital, labor, and services is crucial to cultivating a climate of innovation. These networks can be formal or informal. Some of the various forms of networks include: business incubators, networking websites, and buyer's groups and clubs. Intentionality in creating these networks is particularly important to overcome density barriers common to rural regions that inhibit more organic connections.

***Anchor Institutions*:** Anchor institutions take the shape educational institutions, research groups, or community development financial institutions. They act as recognized major players in initiating and supporting entrepreneurial development within the community. They are responsible for implementing or acting as venues for many of the best practices identified.

Support Infrastructure: It is important that a community maintains the appropriate infrastructure to enable businesses to operate. Lack of infrastructure amenities has acted as a consistent inhibitor to rural economic development. Due to the relative scale and density in rural areas, it is often helpful to establish shared infrastructure, such as an incubator, that enable entrepreneurs to benefit from producing at an economy of scale.

Build on Existing Assets: One of the most powerful components of entrepreneurship as a community development tool is its ability to create investment and empowerment. In order to fully utilize this potential, it is important that high growth entrepreneurship projects have foundations in existing community assets.

Supportive Policies: Although in the past policy has been heavily directed to benefit and attract outside industry, relatively few communities have proactively implemented policy that supports local business and entrepreneurs. Policy plays a huge role in enabling entrepreneurial growth; the private sector alone cannot support comprehensive community development. (Rubin, 2011)

SBA's Microenterprise Resources

The U.S. Small Business Administration offers three federal microenterprise resources: microloans, technical assistance grants, and women's business training. The Microloan Program provides very small loans to start-up, newly established, or growing small business concerns. Under this program, SBA makes funds available to nonprofit community based lenders (intermediaries) which, in turn, make loans to eligible borrowers in amounts up to a maximum of $35,000. Applications are submitted to the local intermediary and all credit decisions are made on the local level. Each intermediary is required to provide business-based training and technical assistance to its microborrowers. Individuals and small businesses applying for microloan financing may be required to fulfill training prerequisites before receiving loan funds.

The PRIME Program provides grants to microenterprise development organizations throughout the country to offer training and technical assistance to low-income entrepreneurs. PRIME also provides grant funding for capacity building (management, outreach, and program design) among community-based microenterprise organizations to more effectively serve clients.

The Office of Women's Business Ownership and the Women's Business Center provide training and counseling services to women entrepreneurs via a network of over 100 centers throughout the country. (U.S. Small Business Administration)

The Role of Banks in Microenterprise

According to the FDIC, banks support mircroenterprise in three ways: lending, investments, and services. Lending can be either directly to the microenterprise or to a non-profit organization or financial intermediary. Examples of such intermediaries include Community Development Financial Institutions (CDFIs), Community Development Corporations (CDCs), minority and women-owned financial institutions, and low income or community development credit unions. Banks may make certain qualified investments in programs or organizations that serve microentreprenuers. A qualified investment is defined as a lawful investment, deposit, membership share or grant that has as its primary purpose community development.

According to the FDIC, banks may also support microenterprise by providing banking services, technical assistance or counseling to microentreprises or to non-profit intermediaries that specialize in microenterprise development. It is often these secondary services that provide the crucial support needed to sustain and stabilize a small business venture.

The Role of Microfinance

In response to the gap in capital many have looked to microfinance and its successes in enabling entrepreneurship abroad. Microfinance is a set of products, including small-scale loans, savings accounts, and insurance. These products or "microloans" support entrepreneurs who cannot qualify for a bank loan, but need capital and other resources to grow or expand a small business. Microfinance, a tool intended to fill a void in the lending market by offering credit products to those without necessary assets to access conventional credit products, was pioneered by Dr. Muhammad Yunus. In the late 1970s, as a professor of rural economics at the University of Chittagong, Yunus initiated a research project exploring the potential of banking services to benefit the poor in rural Bangladesh. The driving philosophy behind the project was that charity does little to mitigate poverty and that all individuals have the potential to lift themselves out of poverty through self-initiative. Yunus developed a system that utilizes social collateral in place of traditional forms of collateral. Potential borrowers form a group. Each group member's ability obtain a loan was contingent upon his fellow group members' successful repayment of a past loan. Yunus's project grew into a formal large scale lending institution, the Grameen Bank, one of the most well known and respected microfinance institutions today. (Wahid and Hsu, 2000) Many other microfinance institutions (MFIs) have since been established in the developing world. A number of them have achieved financial sustainability based on loans that conventional banks would consider too risky. (Richardson, 2009)

The Opportunity Fund has documented the history of the microfinance industry in the U.S., which began in the 1970s, when the need to create an inclusive financial system for those who lacked access to appropriate financial products and services began to get more attention. Communities around the country introduced microlending models to underserved markets, building the case for public and private investment in a new style of economic development. The domestic microfinance industry grew in the 1990s, driven simultaneously by policy reforms and the awareness of the impact of microlending overseas as an anti-poverty strategy. Over the next two decades, U.S. microfinance continued to grow, providing capital to entrepreneurs in cities and rural areas— while demonstrating the need for a more inclusive financial system.

Microfinance in the U.S. has largely failed to achieve the same successes as its foreign counterparts. Although there are an estimated 362 MFIs in the U.S., they tend to operate on a significantly smaller scale and have not been able to reach financial sustainability. It is estimated that these 362 MFIs are only generating around 9,100 microloans a year totaling a 100 million dollar value. This is a small fraction of the 6.2 million small business loans being made by conventional institutions. (Knowledge at Wharton) On average, domestic microfinance institutions are spending a $1.47 for every dollar loaned. (Edgecomb et al., 1996) Domestic MFIs are limited by the complexity of the United States financial system, tough regulation, finance alternatives and culture. (Schreiner and Morduch, 2001) MFIs in the U.S. ultimately suffer from an institutional capacity gap. (Servon et al., 2010) Due to the large amount of technical assistance required to start up a successful business, serving the client often comes at the expense of financial sustainability. The experience of domestic MFIs suggests that "human capital may eclipse financial capital as the greatest constraint to United States microenterprise". (Schreiner and Morduch, 2001)

The Current State of Microlending: Today, there is wide consensus that support for microfinance should be a key part of economic development policy in the United States. (Opportunity Fund) However, a review of the literature suggests a fair amount of skepticism surrounding the idea that microfinance could ever be used in the U.S. as it has been in the developing world due to the complexity of the American economy. It is clear that for the time being the scale and range of products provided by MFIs are not substantial enough to promote entrepreneurialism on a larger community scale. (Knowledge at Wharton) In order to utilize microenterprise as a community economic development strategy, a more comprehensive and assertive approach must be adopted.

Commercial banks are beginning to see microcredit as a business opportunity, but for now, virtually all microlenders in America are organized as non-profit organizations and serve as local intermediaries for federal funds, such as those federal resources described above. (Walker) Microloans are on average around $13,000. Federal funds are first lent to non-profit, community-based organizations that then lend directly to borrowers. The American Recovery and Reinvestment Act (“ARRA”), signed into law in February 2009, included $50 million in federal funds designated as microloans for small businesses. (Walker) There are also a few non-profit organizations in the private sector that issue smaller loans.

For another perspective on small business lending, the National Community Reinvestment Coalition studied 2006 lending data by county. Though none of the Region 5 counties were included in the NCRC study, specific findings are interesting and include the following:

- There is a positive correlation between small business lending and employment; the more small business lending in a county, the higher the employment rate.
- Almost 55 percent of the small businesses studied received loans in counties with less than 20 percent African Americans. This ratio declined to 48 percent in counties with 30 percent or more African Americans, on average.
- Employment rates are lower in counties with higher percentages of minorities and African Americans. The average employment rate is 2 percentage points higher for counties with less than 20 percent African Americans than in counties with more than 30 percent African Americans.

Current Regulation: There is no single regulatory body that specifically oversees microlenders. Aside from the general Internal Revenue Service (“IRS”) regulations and the state-specific small business and consumer laws that apply to non-profits, there are no formal or separate regulations specifically for microlenders. (Walker)

Congress and lending organizations have begun to establish some accreditation standards for microlenders, such as CDFI certification. Additionally, the national trade association of microlenders, the Association for Enterprise Opportunity (AEO) has recently implemented a process that would "establish minimal standards relating to lending and/or training performance, governance and management issues and financial soundness." (Walker)

The Community Reinvestment Act

Commercial banks and other federally insured financial institutions are subject to the Community Reinvestment Act (CRA), among other fair lending laws. The CRA is a federal law that encourages these financial institutions to help meet the needs of their local communities, including serving low- and moderate-income communities by imposing on these institutions an obligation to make credit available to all segments of its communities in its service area. Compliance with this obligation may require the creation of special lending and/or investment programs.

The CRA requires the federal banking regulators to "encourage financial institutions to help meet the credit needs of the local communities in which they are chartered" (Herlihy) In considering the convenience and needs of the community, the Federal Reserve is required, under the CRA (12 U.S.C. §§ 2901–2906), to consider an applicant's record of serving "the credit needs of its entire community, including low- and middle-income neighborhoods, consistent with the safe and sound operation" of the applicant. (12 U.S.C. §§ 2903(a)(1))

The delineation of "community" is of key importance because it defines the areas within which the financial institutions will be held accountable for providing satisfactory and nondiscriminatory services. (Beetham, p. 916-917) The financial institutions are allowed to determine their own "assessment area," which gives them flexibility to outline, to some extent, the scope of their responsibilities. (*See* 12 C.F.R. § 25.41. The regulations define "assessment area" in terms of physical geography (12 C.F.R. § 25.41) and, in general, must consist of one of more metropolitan statistical areas ("MSAs") or one or more contiguous political subdivisions, such as counties, cities or towns. (12 C.F.R. § 25.41(c)(1)) The "assessment area" must also include the "geographies" in which the institution has its main office, branches and deposit-taking ATMs, as well as the surrounding geographies in which it has originated or purchased a substantial portion of its loans. (12 C.F.R. § 25.41(c)(2))

The obligations for a particular financial institution are based on its size: Institutions with assets greater than $1 billion are subjected to the most rigorous exams and are evaluated under a lending test that considers the number and percentages of loans made to low- and moderate-income individuals and communities, as well as the number and types of investments and services in low- and moderate-income communities. The exam for "intermediate small banks," defined as institutions with assets of $250 million to $1 billion, includes a lending test and a community development test. The community development test scrutinizes the amount and responsiveness of a mid-size bank's community development lending, investing, and services. Mid-size banks are no longer required to report small business or community development lending data. (NCRC) Small banks, as defined as institutions with less than $250 million in assets, are evaluated under five criteria: a "reasonable" loan-to-deposit ratio, the percentage of loans in the bank's assessment area, the bank's distribution of loans to individuals of different income levels and businesses and farms of different sizes, the geographic distribution of loans, and the bank's record of responding to written complaints about its lending performance in its assessment area.

An alternative to these agency regulations is available: any lending institution can opt for developing a strategic plan in lieu of a regulator evaluation. A strategic plan is developed in conjunction with neighborhood organizations and seeks to satisfy the credit needs of the community. Federal regulators must approve the strategic plan and rate it at least "satisfactory." (NCRC)

For an in-depth examination of the regulatory regime established by the CRA, see the National Community Reinvestment Coalition website at http://www.ncrc.org.

The CRA has resulted in some increased lending to traditionally unbanked individuals in traditionally unbanked neighborhoods (Walker), but the CRA's impact on *rural areas* today is minimal. This results from the fact that many rural communities are served by smaller banks that are not subject to the same degree of CRA scrutiny as larger banks, and from the absence of well-developed networks of community- based advocacy organizations in many rural areas. (JCHS)

The financial institutions in Region Five that have CRA obligations can meet these obligations by providing credit, investments and banking services that benefit microenterprises. The "Next Steps" section below identifies some additional research the Economic Development Work Group should consider if it wishes to use the CRA to encourage financial institutions to meet the credit needs of microenterprises and entrepreneurs.

Challenges to Microlenders & Microlending

Despite the promise of microlending as an economic development tool, and the incentives built into the system by the CRA, challenges to microlenders and to microlending remain. As discussed above, rural markets are obviously distinct from urban markets (as well as from one another), and a rural entrepreneurmay face unique challenges to obtaining microcredit.

Many rural counties lack a well-developed banking infrastructure and rural borrowers often pay more for some types of credit than their urban counterparts. This may be changing, however, as larger regional and national banks seek to serve the growth segments of the rural economy. (JCHS) Other challenges include changes in the market, the regulatory environment, the financial industry as a whole, and restrictive usury laws, which are state laws that govern interest rate-setting. (Walker) Other challenges include the risk and expense of offering microloans: borrowers lack collateral and expenses include loan initiation, maintenance, and service costs. (Berkman)

In addition to the CRA, other federal statutes govern lender activity and new regulations are afoot. The Dodd-Frank law passed by Congress last year will give U.S. financial regulations a significant overhaul. New agency rules are expected as soon as fall 2011. Also, there is a newly formed regulatory agency, the Consumer Financial Protection Bureau (CFPB), and compliance with as-of-yet unfamiliar agency actions will generate new costs for financial institutions. The regulatory experience from the perspective of the regulated institutions is undergoing significant changes, and this raises many unknowns. Clearly, the economic downtown of the last few years has meant a new set of priorities for financial institutions: private sector risk management practices and public sector oversight of the financial system. Both of these elements will have an effect on lenders' willingness to participate in microcredit programs.

Based on the successes and social outcomes of domestic microenterprise financing, non-profit institutions, as well as commercial lenders, should continue to include robust microcredit programs in their portfolios. The lenders should make capital available to the entrepreneurs who are catalyzing economic development in rural regions.

Entrepreneurship Development & the HUD Sustainability Principles

In 2009 the U.S. Department of Housing and Urban Development partnered with the Department of Transportation and Environmental Protection Agency to launch the Sustainable Housing and Communities Initiative. The interagency planning effort is intended promote the holistic development of more equitable communities across the country. Together they developed six livability principles to act as a foundational vision for their collaboration. (Partnership for Sustainable Communities)

Although these principles primarily focus on infrastructure and the built environment, they also provide an interesting framework to evaluate the ultimate sustainability of entrepreneurship as a community economic development tool. The following is a brief investigation looking at how entrepreneurship relates or builds upon each of these livability principles, and in many cases vice-versa. Identified connections are in no way exhaustive, but intended as a launch pad for further exploration.

- **Provide more transportation choices**. Develop safe, reliable, and economical transportation choices to decrease household transportation costs, reduce our nation's dependence on foreign oil, improve air quality, reduce greenhouse gas emissions, and promote public health.

A healthy economy stimulated by entrepreneurship allows for increased community investment in infrastructure. Lifestyle entrepreneurs promise to build up density through downtown revitalization, which would enable necessary density and activity to offer more public transportation options and encourage pedestrian scale environments.

Conversely, transportation-related infrastructure is very important to the development of entrepreneurial business. Lack of such amenities often limits an entrepreneur's market and ability to expand.

- **Promote equitable, affordable housing**. Expand location- and energy-efficient housing choices for people of all ages, incomes, races, and ethnicities to increase mobility and lower the combined cost of housing and transportation.

Entrepreneurship has potential to contribute to the soft services often complimentary to affordable housing. This is particularly true in the rural context, as there is a large senior population. Entrepreneurs are potential providers of these services.

There is huge potential in entrepreneurship to build community cohesion, and awareness of community needs, such as affordable housing

- **Enhance economic competitiveness**. Improve economic competitiveness through reliable and timely access to employment centers, educational opportunities, services and other basic needs by workers, as well as expanded business access to markets.

Building entrepreneurial communities is a new paradigm in creating competitive advantage in rural communities. Potential for developing a competitive advantage is enhanced when, as previously discussed, entrepreneurship and industry cluster strategies are implemented together.

- **Support existing communities**. Target federal funding toward existing communities—through strategies like transit oriented, mixed-use development, and land recycling—to increase community revitalization and the efficiency of public works investments and safeguard rural landscapes.

Not only do entrepreneurial jobs provide community members with the employment necessary to stay within their communities, but they also provide them with a tool to build and shape their communities as they see fit.

Retrofitting of the landscape suggested under this principle increases the viability of local entrepreneurs' success by creating an environment beneficial to local business.

- **Coordinate and leverage federal policies and investment**. Align federal policies and funding to remove barriers to collaboration, leverage funding, and increase the accountability and effectiveness of all levels of government to plan for future growth, including making smart energy choices such as locally generated renewable energy

The development of entrepreneurial communities is greatly enabled by policy promoting a beneficial business climate. It is important that communities identify policies that are both inhibit and incentivize entrepreneurial activity and evaluate potential for amendments.

- **Value communities and neighborhoods**. Enhance the unique characteristics of all communities by investing in healthy, safe, and walkable neighborhoods—rural, urban, or suburban.

The idea of the entrepreneurial community is deeply rooted in generating value through the emphasis of unique strengths of each community. Through utilizing indigenous knowledge and assets, rural communities are able to develop competitive advantage and participate in a global economy.

Next Steps

Creation of entrepreneurship clearly comes with its own unique set of challenges and opportunities. To better evaluate the potential role that entrepreneurial development could play in Region Five, the Economic Development Work Group should consider these next steps:

- As Region Five works to develop successful industrial and commercial clusters, the Economic Development Work Group could explore the role that entrepreneurship and microbusiness development could play in increasing cluster viability for large ventures, while simultaneously providing support for the smaller enterprises.
- If it has not done so, the Economic Development Work Group might research demographically comparable communities in other regions and model economic development strategies that have been successful in catalyzing and sustaining entrepreneurship and microbusiness elsewhere.

- The Economic Development Work Group could survey small business owners and entrepreneurs about their experience obtaining credit in the region, and then use this information to identify unmet needs and design additional programs.
- The Economic Development Work Group could identify the financial institutions in Region Five that are subject to the CRA, examine CRA reports for those institutions to determine how they currently help meet the community development, small business and microenterprise needs in the Region, and identify how the institutions define their "community needs". This information could then be used to evaluate the impact the CRA has on Region Five.
- The Work Group should review any strategic plans created as an alternative to CRA regulations and whether those plans satisfy the credit needs of the community.
- The Economic Development Work Group could also explore ways to create a greater network of support services for small businesses and entrepreneurs such as low or no cost technical and professional services.
- The Economic Development Work Group could examine the state and local policies that influence and impact the entrepreneurial climate in Region Five and consider advocating for policies with greater favorability toward microenterprise.
- In crafting its sustainability plan, the Economic Development Work Group should incorporate the best practices discussed above.

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