Countering the Rhetoric of Emerging Domestic Markets: Why More Information Alone Will Not Address the Capital Needs of Underserved Communities

Julia Sass Rubin1

Abstract
This article critiques the idea that the private sector can take the lead in addressing the capital needs of underserved communities, focusing specifically on the emerging domestic markets approach advocated by Milken Institute researchers. This approach has three limitations. First, it treats all underserved communities as interchangeable, ignoring that they differ in important ways in the nature and causes of their capital constraints. Second, it claims that underserved communities lack access to capital primarily as a result of information failure, overlooking numerous other obstacles that discourage investment in such communities. Third, its overarching assumption that the private sector can take the lead in meeting the capital needs of underserved communities is unrealistic because it fails to address these additional barriers to investment. The article recommends a more individualized approach to understanding the capital needs of underserved communities and recognition of the need for public sector leadership in solving this problem.

Keywords
access to capital, emerging domestic markets, Michael Porter, underserved communities, venture capital

The economic potential of underserved communities, such as those located in inner-city geographies or populated by people of color, has received substantial attention over the past decade. Urban scholars have written about the need to invest in such communities for decades (e.g., Bates, 1991, 1994; Vietorisz & Harrison, 1970). The issue gained broader awareness, however, after being championed by Harvard Business School professor Michael Porter. Porter (1995, 1997) argued that underserved communities should be viewed as markets that are rich in economic opportunities. Those opportunities could best be harvested by the private sector, leading to profits for the private sector and economic prosperity for community residents.

Porter’s (1995, 1997) thesis has been echoed by others (The American Assembly, 1997; Carr, 1999), including a group of researchers at the Milken Institute who have focused specifically on the challenges that underserved communities face in accessing capital. The Milken researchers refer to such communities as emerging domestic markets to highlight their economic potential. They argue that information imperfections are keeping the private sector from recognizing what these markets have to offer.

Increasing prosperity in underserved communities is a very worthwhile goal. In the interest of convincing the private sector that such communities have economic merit, however, both Porter and the Milken researchers have oversimplified their message, losing important distinctions in the process. This oversimplification can have damaging consequences for the very markets that they are trying to assist. Numerous scholars have addressed the shortcoming of Porter’s work (Bates, 1997a; Boston & Ross, 1996, 1997; Goozner, 1998; Harrison & Glaamer, 1997). This article focuses on the limitations of the Milken approach.

The critique is threefold. First, the Milken researchers treat all underserved communities as interchangeable, not acknowledging that they differ in important ways in the nature and causes of their capital constraints. Second, they claim that underserved communities lack access to capital primarily as a result of information failure, overlooking numerous other obstacles that discourage investment in such communities. Third, their overarching assumption that the private sector can take the lead in meeting the capital needs of underserved communities is unrealistic because it fails to address these additional barriers to investment. The article recommends a more individualized approach to understanding the capital needs of underserved communities and recognition of the need for public sector leadership in solving this problem.

1Rutgers University, New Brunswick, NJ, USA

Corresponding Author:
Julia Sass Rubin, Edward J. Bloustein School of Planning and Public Policy, Rutgers University, 33 Livingston Avenue, Room 544, New Brunswick, NJ 08901, USA
Email: jlsrubin@rutgers.edu
of their capital constraints. These differences matter very much for framing an appropriate response to the problem. Second, the Milken researchers inaccurately claim that underserved communities lack access to capital primarily as a result of information failure, ignoring the numerous other obstacles that raise costs and discourage private sector investment in such communities. Overcoming these additional obstacles requires much more than improved information—it requires subsidy—a fact that the Milken approach obscures and potentially discourages. Third, the Milken researchers’ assumption that the private sector can take the lead in meeting the capital needs of underserved communities is unrealistic because it fails to address these additional barriers to investment. Instead, the public sector must initiate a solution by providing the incentives necessary to attract private sector involvement.

The intention in making these critiques is not to discourage the private sector from investing in underserved communities or to brand some geographies and populations as less worthy of such investment. Rather, it is to push for a more sophisticated understanding of what underserved communities need—one that does not obscure or ignore the complexities of the problems—to ensure that these communities are not left behind by either private or public sector investors.

This article proceeds as follows. The first section details the specific arguments put forth by the Milken researchers. The second section refutes the idea that underserved communities are homogenous by reviewing the literature on how such populations and geographies differ from each other in the nature and causes of their capital constraints. The third section takes issue with the idea that communities are underserved solely because of information failure. It examines communities that lack access to venture capital to highlight additional obstacles to investment that such communities must overcome and to argue that such obstacles discourage a private sector-led solution. The article concludes with recommendations for how the public and private sectors can best address the capital needs of underserved communities.

The Emerging Domestic Markets Idea and Its Antecedents

The idea that underserved communities can experience economic prosperity through the efforts of the private sector reemerged in the mid-1990s in two influential (and controversial) articles about the economic potential of inner-city markets (Porter, 1995, 1997). Porter argued that prior efforts to foster economic development in inner cities had “been based on heavy subsidies and on distorting or blunting market forces” (Institute for Strategy and Competitiveness, 2008). Porter (1995) felt that based on economic self-interest and genuine competitive advantage—not through artificial inducements, charity, or government mandates. (pp. 55-56)

For Porter, one of the main barriers that kept inner-city markets from developing was a lack of access to capital, especially equity capital. Consistent with his broader theme, he argued that “the most important way to bring debt and equity investment to the inner city is by engaging the private sector” (Porter, 1995, p. 69).

Porter’s ideas had a positive reception at The Milken Institute, a think tank established by former Wall Street financier Michael Milken. The institute sees its role as using “capital-market principles and financial innovations to address social and economic challenges, from energy independence to poverty” (Milken Institute, 2008). Beginning in the late 1990s, researchers at the institute started focusing on the capital access side of underserved markets, initially as part of a project for the Minority Business Development Agency of the U.S. Department of Commerce (Harrington & Yago, 1999).

Similar to Porter, the Milken researchers wanted to “shift the common viewpoint” about underserved markets to convince potential private sector investors of their attractiveness (Yago, 2007, p. 1). They felt that terms such as minority businesses carried negative associations for these investors (Yago, Zeidman, & Abuyuan, 2007). They also felt that this terminology was “statistically inaccurate. If you were looking at states like California or New York, that have diverse population groups, ‘minority status’ is a kind of anachronistic term to describe what’s occurring in these demographically- and data-driven markets” (Yago, 2007, p.1).

In 1999, Milken Institute researchers Michael Harrington and Glenn Yago identified another way of referring to such markets. In a report about the problems faced by minority entrepreneurs in obtaining capital to start and grow their businesses, Harrington and Yago wrote that businesses owned by people of color represented an “‘emerging’ and largely untapped domestic market” (p. 1). This market was emerging because people of color were “experiencing higher rates of population growth than whites” and the businesses owned by people of color were “growing even faster than the population in terms of both numbers of new firms and revenues.” However, the growth of this market was “being constrained by inadequate capital access” (Harrington & Yago, 1999, p. 1).

Harrington and Yago (1999) based their emerging domestic markets construct on the international development terminology coined by Antoine van Agtmael of the World Bank (Yago, Zeidman, & Abuyuan, 2007). They hoped to emulate Agtmael’s successful reframing of how certain international markets were viewed from being underdeveloped to emerging as he shifted the emphasis of his analysis from these markets’ levels of indebtedness to their levels of growth (Yago, 2007).
The initial usage of the emerging domestic markets terminology by Harrington and Yago (1999) was in the context of entrepreneurs of color only. However, Milken researchers broadened the term’s application substantially in 2003 and again in 2007 to include,

- ethnic- and women-owned firms, urban and rural communities, companies serving low-to-moderate-income populations, and other small- and medium-sized businesses . . . people of color (African-Americans, Latinos/Hispanics, Asian Americans/Pacific Islanders and Native Americans), women and low-to-moderate-income communities (LMI) (both businesses located there and firms owned by LMI entrepreneurs). (Yago, Zeidman, & Abuyuan, 2007, pp. 1-2)

However, this growth potential was being constrained by unequal access to capital:

Despite their growth, the ability of [emerging domestic market (EDM)] businesses to grow their revenue remains constrained. While still marked, the growth rate of EDM firms’ sales does not match that of their numbers, indicating smaller size. . . . Even after controlling for a variety of factors (e.g., education, experience, industry, location), it is clear from research that EDM firms receive less capital and on less advantageous terms. Without equal access to the full array of financial products on the market, EDM businesses will not grow to their potential. And that would hinder the nation’s economic growth. (Yago, Zeidman, & Abuyuan, 2007, pp. 3-4)

For the Milken researchers, the primary reason

that emerging domestic markets face capital constraints is information asymmetries—the lack of robust data on the markets. Without comprehensive, reliable demographic and financial information, financial decision makers, business leaders and public policy officials are unable to price risk and evaluate opportunities effectively. (Yago, Zeidman, & Abuyuan, 2007, p. 15).

The solution they propose is a comprehensive effort “to build a relational database to pool diverse data, masked to preserve confidentiality” that could be used by banks and other financial institutions to validate the economic potential of underserved markets (Yago, Zeidman, Magula, & Sederstrom, 2007, p. 17).

The Milken researchers have worked to expand adoption of the emerging domestic markets framework by setting up The Center for Emerging Domestic Markets at the Milken Institute to serve as “a clearinghouse for information, a gathering place for education and networking, and a laboratory for innovation in financing businesses in emerging domestic markets, whose purpose is to increase the flow of capital to America’s emerging domestic markets” (Milken Institute, 2008). They have also actively promoted the emerging domestic markets construct through conferences, presentations, research, and consulting work (Milken Institute, 2008).

Their efforts have paid off with policy makers, practitioners, and academics. The emerging domestic markets idea was integral to former California State Treasurer Phil Angelides’ “Double Bottom Line” initiative, which resulted in the state’s two largest public pension funds adjusting their investment parameters to place greater emphasis on emerging domestic markets. It also led the California State Assembly to set up an emerging domestic market advisory group, “to create a more efficient financial ecosystem for emerging domestic markets” (California State Assembly, 2008).

Practitioners who have adopted the emerging domestic markets idea include the National Association of Investment Companies (NAIC), the trade association of venture capital funds that invest in companies owned by people of color. NAIC began using the term to refer to its target markets and changed the title of its quarterly publication to The Journal of EDM Finance. University of Virginia Darden Business School’s Black Business Student Forum has hosted three annual emerging domestic markets conferences with the main goal being to promote “the practical importance of emerging domestic markets . . . [and to] reposition these markets as a lucrative business opportunity rather than an exercise in social responsibility” (Darden Business School, 2006, p. 1).

The Milken researchers introduced the emerging domestic markets construct into academic discourse, most significantly via a collection of papers by leading scholars that was edited by Yago, Barth, and Zeidman (2007) of the Milken Institute and published under the title Entrepreneurship in Emerging Domestic Markets. The Milken researchers also partnered with the San Francisco Federal Reserve to publish a special issue of the journal Community Development Investment Review (2007) on the topic of emerging domestic markets, which included articles by well-known business and public policy scholars. Finally, the Milken researchers regularly present the concept at academic conferences and academics cite the numerous Milken Institute publications that promote the idea of emerging domestic markets.

Although the Milken researchers’ objective of increasing access to capital in underserved communities is very worthwhile, their approach for reaching this goal is problematic. The following section of this article details the first critique of the emerging domestic markets framework—that it treats all underserved communities as homogenous, failing to
Cordero-Guzmán (2007) conclude that existing literature on Hispanic entrepreneurship, Robles and 2006; Ruiz-Vargas, 2000). For example, after reviewing the experience as a whole varies significantly depending on the numerous studies have documented that the entrepreneurial ability to access capital diverge dramatically.

The levels and natures of capital constraints also differ greatly across and within different races and ethnicities. Although research that specifically focuses on access to capital is limited, numerous studies have documented that the entrepreneurial experience as a whole varies significantly depending on the race, ethnicity, and immigration status of the entrepreneur (Bates, 1990; Carvajal, 2004; Delgado, 1998; Mora & Davila, 1999; Cavalluzzo, Cavalluzzo, & Wolfen, 2002; Cavalluzzo & Wolfen, 2005; Coleman, 2002, 2003; Mitchell & Pearce, 2004). The literature has been more mixed, however, when it comes to women’s access to credit. Not only has debt capital become significantly more accessible to women entrepreneurs (Greene, Brush, Hart, & Saparito, 2001), but attempts to link discrimination to any continuing limitations in women’s access to credit have also been inconclusive (Buttner & Benson, 1988; Cavalluzzo & Cavalluzzo, 1998; Coleman, 2000; Walker & Joyner, 1999).

The levels and natures of capital constraints also differ greatly across and within different races and ethnicities. Although research that specifically focuses on access to capital is limited, numerous studies have documented that the entrepreneurial experience as a whole varies significantly depending on the race, ethnicity, and immigration status of the entrepreneur (Bates, 1990; Carvajal, 2004; Delgado, 1998; Mora & Davila, 2006; Ruiz-Vargas, 2000). For example, after reviewing the existing literature on Hispanic entrepreneurship, Robles and Cordero-Guzmán (2007) conclude that

One cannot simply extrapolate and predict similar entrepreneurial patterns without taking into account the country of origin, transnational ties to the home country, location of business (ethnic enclaves versus mainstream markets), and parallel sociodemographic profiles of the group in question. (p. 22)

Furthermore, research specifically on access to capital for various immigrant communities of color has documented that both debt and equity capital are available via coethnic banks, rotating credit associations, and community funds (Bates, 1994; Bonacich & Modell, 1980; Butler & Greene, 1997; Chotigeat, Balsmeier, & Stanley, 1991; Greene & Butler, 1996; Light & Bonacich, 1988). Moreover, in at least some of these communities, such capital is potentially more plentiful than for the native-born White communities (Light, 2002).

The distinctions in terms of access to capital do not also depend solely on membership in a specific ethnic community. Chaganti and Greene (2002) find that, even within such communities, the availability of capital varies by levels of “personal involvement of the entrepreneur in the ethnic community instead of [their] reported ethnic grouping” (p. 1). Similarly, Choi’s (2004) study of the Korean immigrant community in Los Angeles demonstrates that because Korean churches act as small business incubators in Koreatown, access to capital is partly determined by membership in specific religious congregations.

In other words, not only do Blacks, Hispanics, and Asians differ from each other in their access to capital, but the capital constraints faced by immigrants vary from those of the native born, those of African Americans differ from those of Caribbean Black Americans, those of Puerto Rican Americans differ from those of Cuban Americans, and those of Laotian Americans differ from those of Korean Americans. Additionally, the ease with which individuals within these ethnicities can access capital depends on factors such as their individual attachment to the community and their potential religious affiliation.

In addition to populations, the definition of emerging domestic markets also includes location—whether a community is inner city or rural. This geographic definition is problematic for two reasons. First, many urban and rural geographies are not actually emerging but instead are experiencing declines both in population and economic well-being (Barley, 2003; Kirschner, Berry, & Glasgow, 2006; Rappaport, 2003). Second, as is the case with populations, rural and urban geographies differ from each other on a number of attributes (Rappaport, 2003; Whitener & McGranahan, 2003), including their levels of access to capital (Carlson & Chakrabarti, 2007); nor are rural or urban geographies internally monolithic. Although Wall Street and inner-city Detroit are both urban, their levels of economic prosperity and ability to access capital diverge dramatically.

The Milken researchers also fail to differentiate between communities that lack access to debt and those that lack access to equity capital. Although some geographies and populations lack access to all forms of capital, debt capital is generally much more readily available than equity. Moreover, the lack of access to equity capital is not just limited to the communities and populations included in the emerging domestic markets framework. The overwhelming majority of all U.S. entrepreneurs are not able to access the levels of equity capital that they need (Bates & Bradford, 1992; Maier & Walker, 1987).

It could be argued that these are nuanced academic distinctions that are lost on the real-world audience that the Milken
researchers are trying to influence. However, these distinctions have tremendous relevance for addressing the problem, as demonstrated in the next section of this article. The concern is that, by treating underserved geographies and populations as interchangeable, the Milken researchers are communicating to policy makers and investors that the distinctions among these communities are not significant, potentially obstructing solutions to the very problems they are working to address.

Rather than analyzing underserved communities in the aggregate, as the Milken researchers have done, each one must be examined individually to understand exactly what kind of capital—debt or equity—is in short supply and why that is the case. Only then can appropriate solutions be crafted.

Section 3 of this article demonstrates the importance of such a fine-grained approach, focusing specifically on markets underserved by institutional sources of equity, a topic that has received much less scrutiny from the academic community than access to debt. This analysis also highlights the two additional fallacies of the emerging domestic markets approach—that the shortage of capital in underserved communities is primarily the result of information failure and that the private sector can take the lead in meeting the capital needs of underserved communities.

**Which Markets Lack Access to Institutional Private Equity Capital and Why**

Private equity is an asset class that consists of equity investments in privately owned companies—those not traded on a public stock exchange. Venture capital is a subcategory of private equity that refers to equity investments in young companies, ranging from early stage to expansion. Most venture capital firms are partnerships of professional fund managers who raise money from pension funds, financial institutions, endowments, wealthy individuals, and corporations and invest those funds in a way that maximizes profits for their investors.

Venture capital investments tend to occur in locations that have strong deal flow in the form of potential investment opportunities, particularly technology-related investments. In addition to investment opportunities, such locations also have the supporting infrastructure—the technological, managerial, legal, and financial expertise—that is necessary to take ideas to market (Florida & Kenney, 1988a, 1988b; Florida & Smith, 1991, 1992). Venture capital fund managers also prefer to invest in companies that are geographically close to where the managers are located to minimize travel time and maximize the ability to collect information about those firms (Chen, Gompers, Kovner, & Lerner, 2009; Florida & Kenney, 1988a, 1988b; Florida & Smith, 1991, 1992; Powell, Koput, Bowie, & Smith-Doerr, 2002; Sorenson & Stuart, 2001; Zook, 2005).

Areas such as Silicon Valley in California and Route 128 in Massachusetts embody such characteristics and consistently draw a disproportionate share of institutional venture capital dollars. Between 2006 and 2008, these two states accounted for 60% of all dollars invested in the United States. The geographic concentration of the venture capital industry goes beyond these two states, however, with just 10 states accounting for 84% of all the dollars invested between 2006 and 2008 (PriceWaterhouseCoopers, 2009). Such geographic concentration has remained remarkably consistent for more than two decades (Florida & Kenney, 1988a, 1988b; Mason, 2007).

Venture capital investments also are highly concentrated by industry and size of investment. Just five industries—software, biotechnology, medical devices and equipment, industrial/energy, and telecommunications—received almost 66% of all the dollars invested between 2006 and 2008 (PriceWaterhouseCoopers, 2009). Over the past two decades, investments per company have increased as the capitalization of the average venture capital fund grew from $30 million in 1985 to almost $176 million in 2006 (National Venture Capital Association, 2008; Onorato, 1997). Because larger investments have transaction costs comparable with those of smaller investments, venture capitalists have increased their investment sizes in line with their capitalization levels to reduce transaction costs and increase profits. In 2008, the average investment for the venture funds that participated in the PriceWaterhouse MoneyTree Survey was $7,024,800 per company, further limiting venture capital investments to portfolio firms that can absorb fairly large infusions of capital.

This concentration of venture capital investments by geography, industry, and size of investment helps explain why, historically, fewer than 3% of all privately held companies in the United States have been able to access venture capital dollars (Bates & Bradford, 1992; Maier & Walker, 1987). Some populations and geographies, however, appear to be disproportionately underserved by institutional sources of venture capital. Women-led firms, for example, drew only 5% of all U.S. venture capital investments in 2001 (Brush, Carter, Gatewood, Greene, & Hart, 2001). Even this small percentage reflected an increase from the 2.6% of all venture capital investments that went to women-led firms between 1957 and 1998 (Brush, Carter, Greene, Hart, & Gatewood, 2002).

Historically, people of color also have been disproportionately underserved by institutional sources of venture capital. For example, Bates and Bradford’s (1992) analysis of the 1982 Characteristics of Business Owners Survey found that African Americans were limited in their access to venture capital, even when controlling for other variables.

Some geographies also are disproportionately underserved by institutional venture capital. As Table 1 illustrates, 18 states jointly accounted for less than 1% of all the dollars invested by venture capital firms between 2006 and 2008, with each state receiving less than $100 million over that 3-year period. These states are primarily rural, although venture capital is also in short supply in many urban areas, particularly those that are economically distressed (Carlson & Chakrabarti, 2007).
Determining why these populations and geographies are disproportionately underserved highlights the importance of examining such communities individually rather than aggregating them under the emerging domestic markets umbrella. The Milken researchers’ hypothesis that the primary reason these “emerging domestic markets face capital constraints is information asymmetries—the lack of robust data on the markets” (Yago, Zeidman, & Abuyuan, 2007, p. 15) appears to fit the data when it comes to minority and female entrepreneurs. Specifically, it is likely that these populations are underserved in part because of information asymmetries that result from a lack of common networks between a primarily White and male venture capital industry and an increasingly large population of minority and female entrepreneurs. Venture capitalists rely heavily on their networks in identifying investment opportunities, conducting due diligence on those opportunities, and monitoring investment performance (Mason, 2007). Because traditional venture capitalists’ networks include few women and people of color, they have limited access to and understanding of companies owned by these populations. This translates into higher search costs in identifying, conducting due diligence on, and monitoring firms owned by women and people of color (Brush et al., 2001, 2004). Brush et al. (2001, 2004) came to this conclusion after conducting an extensive analysis of women entrepreneurs’ access to venture capital and eliminating alternative explanations for why women-owned firms received such a small percentage of all venture capital investments. This hypothesis is further supported by the fact that this small percentage has grown as the number of women in the venture capital industry, whose own networks include women entrepreneurs, has increased (Brush et al., 2001, 2004).

The network commonality hypothesis is also consistent with Bates and Bradford’s (2007) research on access to venture capital for companies owned by people of color. Specifically, Bates and Bradford examined minority-focused venture capital funds, a specialized subset of the broader venture capital industry that targets its investments to companies owned by entrepreneurs of color. They found that minority-focused venture fund managers identified the bulk of their investment opportunities through relationship networks that are different from those used by conventional venture capitalists (Bates & Bradford, 2002, 2003a, 2003b, 2007, 2008; Bates, Bradford, & Rubin, 2006). These funds’ strong financial performance undermines the possibility that companies owned by entrepreneurs of color attract fewer venture capital investments because they do not represent a financially attractive investment opportunity.

Although information asymmetry may help shed light on why women and minority entrepreneurs have been underserved by the venture capital industry, it is a much less fitting explanation for the lack of venture capital in rural and distressed urban geographies. A more compelling argument is that venture capitalists are discouraged from investing in companies located in these geographies by the presence of obstacles that increase costs and reduce their profitability.

Table 1. Eighteen States That Each Received $100 Million or Less in Private Equity Dollars (2006-2008)

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Alabama</td>
<td>0.09</td>
<td>1.5</td>
<td>45.7</td>
</tr>
<tr>
<td>Alaska</td>
<td>0.00</td>
<td>0.2</td>
<td>35.3</td>
</tr>
<tr>
<td>Arkansas</td>
<td>0.05</td>
<td>0.9</td>
<td>48.2</td>
</tr>
<tr>
<td>Delaware</td>
<td>0.09</td>
<td>0.3</td>
<td>28.2</td>
</tr>
<tr>
<td>Hawaii</td>
<td>0.05</td>
<td>0.4</td>
<td>9.4</td>
</tr>
<tr>
<td>Idaho</td>
<td>0.06</td>
<td>0.5</td>
<td>36.5</td>
</tr>
<tr>
<td>Iowa</td>
<td>0.05</td>
<td>1.0</td>
<td>40.0</td>
</tr>
<tr>
<td>Louisiana</td>
<td>0.05</td>
<td>1.4</td>
<td>30.5</td>
</tr>
<tr>
<td>Maine</td>
<td>0.03</td>
<td>0.4</td>
<td>59.9</td>
</tr>
<tr>
<td>Mississippi</td>
<td>0.01</td>
<td>1.0</td>
<td>53.5</td>
</tr>
<tr>
<td>Montana</td>
<td>0.02</td>
<td>0.3</td>
<td>47.0</td>
</tr>
<tr>
<td>Nebraska</td>
<td>0.03</td>
<td>0.6</td>
<td>31.1</td>
</tr>
<tr>
<td>N. Dakota</td>
<td>0.00</td>
<td>0.2</td>
<td>43.8</td>
</tr>
<tr>
<td>Oklahoma</td>
<td>0.04</td>
<td>1.2</td>
<td>35.2</td>
</tr>
<tr>
<td>S. Dakota</td>
<td>0.01</td>
<td>0.3</td>
<td>48.0</td>
</tr>
<tr>
<td>Vermont</td>
<td>0.07</td>
<td>0.2</td>
<td>62.6</td>
</tr>
<tr>
<td>W. Virginia</td>
<td>0.05</td>
<td>0.6</td>
<td>53.8</td>
</tr>
<tr>
<td>Wyoming</td>
<td>0.01</td>
<td>0.2</td>
<td>35.8</td>
</tr>
<tr>
<td>Total 18 states</td>
<td>0.72</td>
<td>11.3</td>
<td>40.9</td>
</tr>
<tr>
<td>Total U.S.</td>
<td></td>
<td></td>
<td>22.9</td>
</tr>
</tbody>
</table>

The literature has documented the existence of such obstacles to investing in rural and distressed urban geographies in terms of both demand for and supply of venture capital. In rural areas, for example, there is less demand for traditional venture capital investments as a result of the following:

- Lower population densities, which translate into fewer companies that can demonstrate the growth trajectory and potential for profitable exits demanded by traditional venture capitalists (Barkley, 2003; Barkley & Markley, 2001; Freshwater, Barkley, Markley, Rubin, & Shaffer, 2001; Rubin, 2008)
- The absence of a developed investment infrastructure, entrepreneur support networks, and entrepreneurial culture (Barkley, 2003; Barkley & Markley, 2001; Freshwater et al., 2001; Hughes, Mallory, & Szabo, 2004)
- A lack of understanding of how venture capital works (Barkley & Markley, 2001; Freshwater et al., 2001)
- An unwillingness to give up company ownership on the part of local entrepreneurs (Barkley & Markley, 2001; Freshwater et al., 2001; Hughes et al., 2004; Rubin, 2008)

The lower rates of demand for venture capital translate into higher search costs for venture capitalists. Whereas a venture capitalist in California’s Silicon Valley might receive 400 proposals from which to select the top few investment opportunities, a venture capitalist in northern Maine is likely to see a fraction of that total. The Maine venture capitalist also may have to identify and pursue potential portfolio companies, rather than waiting for them to come to her, and devote additional resources to preparing her portfolio companies for investment (Rubin, 2010a).

Even when attractive investment opportunities are present in rural areas, they must compete for a more limited supply of venture capital as a result of the greater difficulty and travel time it takes venture capitalists to reach potential portfolio companies (Barkley & Markley, 2001; Brophy, 1997; Freshwater et al., 2001) and the limited access to specialized workforces and experienced management, post investment (Barkley, 2003; Barkley & Markley, 2001).

Some of these challenges—such as the absence of developed investment infrastructure, entrepreneur support networks, and entrepreneurial culture, and limited access to specialized workforces and experienced management—also have been documented in distressed urban areas. Additionally, investors in distressed urban areas must overcome the presence of both real and perceived higher crime rates (Boston & Ross, 1996, 1997, multiple contributors).

As long as high-quality investment opportunities are available elsewhere, purely profit-oriented venture capitalists have little incentive to take on these additional costs. As a result, most of the venture capital funds that invest in rural and distressed urban geographies are developmental in nature (Barkley, 2003; Barkley & Markley, 2001; Freshwater et al., 2001). Rather than investing with a single bottom line of profit maximization, they seek both financial and social returns. For developmental venture funds that invest in rural and distressed urban geographies, the social returns are in the form of targeted economic growth and job creation, which provides a mission-related reason for the funds to invest in these more challenging communities (Barkley, 2003; Barkley & Markley, 2001; Freshwater et al., 2001).

Developmental venture funds address the higher costs associated with investing in rural and distressed urban communities through subsidies (Barkley, 2003; Barkley & Markley, 2001). Rubin (2010a) examined 47 such funds, which constitute the majority of geographically focused developmental venture capital funds created over the past 40 years and found that all 47 relied on subsidies, primarily from the public sector, to offset the higher costs they faced in addressing the supply- and demand-side challenges that rural and distressed urban communities present.

Over the past decade, sources of subsidy for developmental venture capital have decreased significantly, for both economic and political reasons. This has resulted in a dramatic reduction in the number of new geographically focused developmental venture funds. Whereas 14 new funds were capitalized between 2000 and 2005, only two new funds were capitalized between 2006 and 2009 (Rubin, 2010a). Without new sources of subsidy, rural and distressed urban communities will be left with even less access to venture capital than they currently have.

The preceding venture capital analysis highlights both the limitations and dangers of the emerging domestic markets approach. By treating underserved communities as interchangeable, emerging domestic markets proponents ignore the very real differences among them in the nature and causes of their capital constraints. In the case of venture capital, for example, populations and geographies are underserved at different levels and for different reasons. Consistent with the emerging domestic markets hypothesis, women and people of color appear to be hindered by information imperfections in the form of network asymmetries. Rural and distressed urban geographies, however, present numerous other obstacles to venture capital investors. By diagnosing the problem as primarily one of information failure, emerging domestic markets’ proponents put forth solutions—more data on the markets—that neglect these additional barriers to investment. Although making additional data available to investors may address the needs of women and minority entrepreneurs, the venture capital analysis suggests that investors may have the necessary data when it comes to rural and distressed urban markets. In fact, they may be unwilling to invest in these markets precisely because they are aware of the higher costs involved in such transactions.

The venture capital analysis also highlights the third fallacy of the emerging domestic markets approach—that the private sector can take the lead in meeting the capital needs of underserved communities. As long as high-quality investment
opportunities are available elsewhere, strictly profit-oriented venture capital funds have little incentive to take on the additional costs of investing in rural and distressed urban geographies. Even private-sector entities that have both social and financial objectives, such as the developmental venture capital funds, cannot take action without government subsidies. In short, meeting the venture capital needs of underserved communities requires public sector leadership.

Conclusion

The emerging domestic markets approach to investing in underserved communities, articulated by researchers at the Milken Institute, has three important limitations. First, it treats the diverse populations and geographies currently underserved by private sector capital providers as interchangeable, ignoring the fact that they differ in important ways in the nature and causes of their capital constraints. It also treats debt and equity capital as interchangeable, despite the very different factors that inhibit access to each form of capital.

Second, it wrongly asserts that underserved communities lack access to capital primarily as a result of information failure, overlooking numerous other obstacles that raise costs and discourage investments in underserved communities. Third, the Milken researchers’ assumption that the private sector can take the lead in meeting the capital needs of underserved communities is unrealistic because it fails to address these additional barriers to investment.

Although the private sector is unlikely to take the lead in bringing resources to underserved communities, it can play an important role in such an effort. However, oversimplifying the problem or promising unrealistically strong financial returns is not the way to attract private sector investors. Instead, it is necessary to be honest about the challenges that underserved communities may present for such investors and to mitigate those challenges with public sector interventions.

The first step is to identify which communities are underserved and whether they lack access to debt or equity capital. This may require additional research, for example, to determine if entrepreneurs of color continue to be underserved in their access to equity capital. The second step is to examine underserved communities individually to determine why each lacks access to capital. As the analysis of communities underserved by institutional venture capital demonstrates, such communities cannot be lumped together and treated as interchangeable if we want to address what is keeping them from attracting investors.

Finally, the public sector must take the lead in creating an environment that encourages the private sector to help meet the capital access needs of underserved communities. In the case of venture capital, public sector involvement has taken the form of subsidies, via appropriations and tax credits, to offset the higher costs of investing in underserved communities; and mandates, to encourage conventional financial institutions to invest in these markets despite the higher costs. Without such public sector interventions, the private sector is likely to continue bypassing underserved communities.

The desire to rely on the private sector to solve the problems of underserved communities, as expressed by Michael Porter and the Milken researchers, is understandable in light of limited public sector resources and a prevailing political climate that has favored private sector solutions. As the current economic crisis demonstrates, however, the need for government intervention cannot be eliminated by ideology or wishful thinking. Whether by limiting negative excesses or by encouraging positive action, government continues to have an important role to play in ensuring a fair and thriving economy.

Declaration of Conflicting Interests

The author(s) declared no potential conflicts of interest with respect to the research, authorship, and/or publication of this article.

Funding

The author(s) received no financial support for the research, authorship, and/or publication of this article.

Notes

1. In May 2000, Angelides launched “The Double Bottom Line: Investing in California’s Emerging Markets” initiative by releasing a 36-page report with the same name. The influence of the emerging domestic markets idea was apparent in the title and body of the report, which cited both the Milken researchers and Michael Porter in arguing that investment capital should be directed “through state programs and the State’s pension and investment funds—to spur economic growth in those California communities left behind during the economic expansion of the past decade” (Angelides, 2000, p. 1). Angelides’s efforts were supported by the board positions that he, as the state’s Treasurer, held on the two largest public pension funds in the state, CalPERS (California Public Employees’ Retirement System) and CalSTRS (California State Teachers’ Retirement System). For a case study of how CalPERS implemented the changes related to the Double Bottom Line Initiative, see Rubin (IN PRESS).

2. The private equity industry also includes firms that invest in mature companies to facilitate their expansion and restructuring.

3. Although there is substantial ongoing research examining access to debt capital for women and people of color, more current research on access to equity capital for these populations is much more limited. There clearly is a need to address this dearth of information to determine if women and people of color continue to be disproportionately underserved by the venture capital industry.

4. An additional explanation for why women and minority entrepreneurs have been underserved by the venture capital industry is discrimination (Bates & Bradford, 1992).
5. Developmental venture capital funds pursue a range of social objectives, including economic development of distressed urban and rural geographies; creation of high-quality jobs for low-income populations; building wealth for women and people of color; and creation of products that benefit society, such as those that lower poverty or contribute to a cleaner environment. For more on developmental venture capital, see Rubin (2009).

6. On the demand side, for example, the developmental venture capital funds increased their pool of investment opportunities by educating local entrepreneurs about the venture capital process and providing potential portfolio companies with technical assistance to improve their profitability. To address the supply-side limitations, the developmental venture capital funds set up local offices to minimize travel time and insure frequent contact with their portfolio companies. For a more in-depth discussion of how developmental venture capital funds overcome the investment challenges presented by rural and distressed urban geographies see Rubin (2010b).

7. In addition to the venture capital industry, entrepreneurs can access equity from noninstitutional sources such as individual “angel” investors, family members, or personal savings. However, each of these sources presents potential limitations for the populations and geographies discussed in this note. For example, Becker-Blease and Sohl (2007) found that “women entrepreneurs receive a small proportion of the total angel capital awarded” (p. 504), and obtaining capital from family members and personal savings is not an option for entrepreneurs who lack such resources.

8. For a detailed discussion of prior public sector efforts and future recommendations for increasing access to equity capital for underserved geographies and populations, see Rubin (2010b).

References


Bio