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DEVELOPMENT LENDING AND THE COMMUNITY REINVESTMENT ACT

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KEITH N. HYLTON†

INTRODUCTION

I grew up in a city and believe that the economic health of cities can be taken as a sign or predictor of the health of a nation's economy. Many cities in the United States have fared poorly in recent history, losing businesses and wealthy residents to the suburbs. I noticed a familiar pattern as I read a description of the decline of the Roman Empire in Britain:

> This Roman town life did not last. The damage to the well-to-do classes through high taxation; the ruin of trade through depreciation of the coinage and lack of free, productive industry; the multiplication of officials; civil war, and the plunder of cities by rival armies; these were some—though not all—of the reasons why from the middle of the third century the towns began to lose their amenities. In Britain, for example, the *forum* of Wroxeter was destroyed by fire about the year 300; it was never rebuilt. At Silchester there is evidence that towards the later period of the life of the town a less civilized class came into possession of the fine houses and did their cooking on the tessellated pavements. At Verulamium the theatre became a stone quarry.
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> The decay of town life did not mean at once the end of Roman culture. The economic basis of the Empire was agricultural, and the Roman *villa*, like the Roman army and bureaucracy, survived long after the Roman town had become a squalid slum.[1]

If we take out the reference to civil war, most of the points in E.L. Woodward's quick list of reasons for decline apply to the expe-

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* These remarks were prepared for the Issues in Community Economic Development symposium held at the Western New England College School of Law on March 24, 2006, and provide a brief overview of the law-and-economics literature on urban economic development. Professor Hylton participated in a panel entitled "The Future of the Community Reinvestment Act."

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1. E.L. WOODWARD, HISTORY OF ENGLAND FROM ROMAN TIMES TO THE END OF WORLD WAR I, at 4-5 (Harper & Row 1962).

rience of many American cities in the 1960s and 1970s. Even the reference to rival armies has some validity: drug prohibition has spawned rival private militias that battle over market territory within cities.

While the news has improved in many cities over the last two decades,[2] there are also many cases where the turnaround has yet to occur. The full story of the Roman Empire should give us sufficient motivation to find ways to improve the economic health of American cities.

One approach is finance. There is now a growing body of empirical literature that demonstrates the connection between economic growth and the strength of financial markets.[3] If this connection is true of cities as well, the obvious implication is that the economic turnaround of cities can be enhanced by expanding financial markets to distressed communities within cities. In any event, belief in this proposition led me to study this topic years ago.

In a series of articles on community-development lending published in the late 1990s, I criticized the Community Reinvestment Act (CRA).[4] Criticizing the CRA, however, was not the sole focus of these articles. I offered a theoretical framework for analyzing the statute that I hoped would be useful to scholars who attempted either to justify or to condemn the statute. I also offered alternatives to the current approach, pointing especially toward the subsidization of economic-development efforts.

Looking back, it appears that I underestimated the degree to which the political controversy surrounding the CRA would color the treatment some later scholars would give to my work. I have been disappointed to find later writers describing me as a "critic" of the statute,[5] along with other "critics" such as Charles Calomiris,[6]

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2. *America's Cities: They Can Yet Be Resurrected*, ECONOMIST, Jan. 10, 1998, at 17.

3. *See, e.g.*, Ross Levine, *Finance and Growth: Theory and Evidence* (Nat'l Bureau of Econ. Research, Working Paper No. 10766, 2004), *available at* http://www.nber.org/papers/w10766.

4. Keith N. Hylton & Vincent D. Rougeau, *Lending Discrimination: Economic Theory, Econometric Evidence, and the Community Reinvestment Act*, 85 GEO. L.J. 237 (1996) [hereinafter Hylton & Rougeau, *Lending Discrimination*]; Keith N. Hylton & Vincent D. Rougeau, *The Community Reinvestment Act: Questionable Premises and Perverse Incentives*, 18 ANN. REV. BANKING L. 163 (1999) [hereinafter Hylton & Rougeau, *Perverse Incentives*]; Keith N. Hylton, *Banks and Inner Cities: Market and Regulatory Obstacles to Development Lending*, 17 YALE J. ON REG. 197 (2000) [hereinafter Hylton, *Banks and Inner Cities*].

5. DAN IMMERGLUCK, CREDIT TO THE COMMUNITY: COMMUNITY REINVESTMENT AND FAIR LENDING POLICY IN THE UNITED STATES 278 n.1 (2004); Michael Barr,

Michael Klausner,[7] Jonathan Macey,[8] Geoffrey Miller,[9] George Benston,[10] Peter Swire,[11] and Lawrence White.[12] Not that I mind the company; the list of CRA co-critics makes an extremely impressive team of scholars in law and economics. What troubles me about the critic label is that I, as well as many of the others listed as critics, have tried to set out theoretical and empirical hypotheses that would be equally useful to proponents and critics of the statute. In other words, it was my aim to set out a road map for analyzing community-development finance efforts as well as to criticize the shortcomings of the existing approach. Moreover, the label "critic" masks the variety of views expressed by scholars who have criticized the statute. Indeed, many of the so-called critics have criticized other critics in addition to criticizing aspects of the CRA. To label them all as one monolithic mass obscures the record of scholarship in this field and fails to respect the sometimes-divergent individual messages offered by each.

I will make three arguments below. First, I will briefly review the key points of my earlier papers. Second, I will respond to a few of the assertions made by "the critics of the critics." Lastly, I will discuss the way forward: specifically, principles for urban development and legislative reform.

I. The Law and Economics of Development Lending: A Brief Review

The three articles I wrote on the CRA, two of them coauthored with Vincent Rougeau, provide different ways of think-

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Credit Where it Counts: The Community Reinvestment Act and Its Critics, 80 N.Y.U. L. REV. 513, 518-19 (2005).

6. Barr, *supra* note 5, at 518 n.21 (citing Charles W. Calomiris et al., *Housing-Finance Intervention and Private Incentives: Helping Minorities and the Poor*, 26 J. MONEY CREDIT & BANKING 634 (1994)).

7. *Id.* (citing Michael Klausner, *Market Failure and Community Investment: A Market-Oriented Alternative to the Community Reinvestment Act*, 143 U. PA. L. REV. 1561 (1995)).

8. *Id.* (citing Jonathan R. Macey & Geoffrey P. Miller, *The Community Reinvestment Act: An Economic Analysis*, 79 VA. L. REV. 291 (1993)).

9. *Id.* (citing Jonathan R. Macey & Geoffrey P. Miller, *The Community Reinvestment Act: An Economic Analysis*, 79 VA. L. REV. 291 (1993)).

10. IMMERGLUCK, *supra* note 5, at 278 (citing George Benston, *Discrimination in Mortgage Lending: Why HMDA and CRA Should Be Repealed*, 19 J. RETAIL BANKING SERVICES 47 (1997)).

11. Barr, *supra* note 5, at 518 n.21 (citing Peter P. Swire, *Equality of Opportunity and Investment in Creditworthiness*, 143 U. PA. L. REV. 1533 (1995)).

12. Lawrence J. White, *The Community Reinvestment Act: Good Intentions Headed in the Wrong Direction*, 20 FORDHAM URB. L.J. 281 (1993).

ing about the problem of financing community development. The first, *Lending Discrimination: Economic Theory, Econometric Evidence, and the Community Reinvestment Act* (*Lending Discrimination*), examines the theory and evidence on lending discrimination and its implications for the CRA.[13] In this article, I viewed discrimination as the core market failure to consider, and in this sense parted company with the first legal and economic critique of the CRA, that of Macey and Miller.[14]

I disagreed with Macey and Miller on the market failure question.[15] Macey and Miller were clearly aware of the market failure problem, but they argued as if lending markets were efficient, and consequently, there was no need for government intervention to correct a shortfall in lending in economically distressed communities.[16] My reason for disagreeing was largely personal. It seemed to me obvious that the unemployment and economic decay observed in several American inner cities could not be the result of an efficient market.

However, I did not disagree with all of the points made by Macey and Miller—and indeed, I would question my own work if I found that I disagreed with everything they said. Their points about the burdens imposed and investment disincentives created by the statute seemed largely unassailable and in accord with the evidence. Moreover, the policy question they framed remains the question of the moment: Are the social benefits provided by the statute greater than the social costs?

In the same paper, I discussed empirical issues and provided a preliminary empirical examination of the lending discrimination hypothesis based on lending data provided to the city of Chicago by banks that served as municipal depositories.[17] I stressed the importance of attempting to control for selection effects in any effort to test for discrimination in lending data.[18] For example, if minority

13. Hylton & Rougeau, *Lending Discrimination*, *supra* note 4.

14. *See* Jonathan R. Macey & Geoffrey P. Miller, *The Community Reinvestment Act: An Economic Analysis*, 79 VA. L. REV. 291 (1993).

15. Hylton & Rougeau, *Lending Discrimination*, *supra* note 4, at 238 n.13, 262.

16. Macey & Miller, *supra* note 14.

17. Hylton & Rougeau, *Lending Discrimination*, *supra* note 4, at 253-62, 277.

18. *Id.* at 255, 268-77; *see* Robert P. Trost et al., *Bias in Estimates of Discrimination and Default in Mortgage Lending: The Effects of Simultaneity and Self-Selection*, 9 J. REAL EST. FIN. & ECON. 197 (1994); Faye Steiner, *Quantifying Discrimination in Home Mortgage Lending: Estimation of Loan Price Elasticities Across Products and Races* (Stanford Inst. for Econ. Pol'y Research, Discussion Paper No. 00-15, 2000), *available at* http://ssrn.com/abstract=262733.

mortgage applicants prefer to live in areas where mortgage-default risks are higher, this might lead to higher observed rejection rates even in the absence of discriminatory preferences on the part of lenders.

The discrimination hypothesis led me into an exploration of the economic theory of discrimination and its application to the lending market. Following the economic literature, I distinguished between *taste-based* and *statistical* discrimination.[19] The former type of discrimination is based on a supposed "taste for discrimination" possessed by the economically advantaged party (e.g., the employer, the lender, etc.).[20] The second type of discrimination, statistical, is based on the efforts of the advantaged party to use some superficial characteristic, such as the race of the applicant or the racial composition of the applicant's neighborhood, to determine the profitability of an action that affects the applicant (e.g., denial of job, denial of loan, etc.).[21]

To my surprise, I found that the statistical discrimination theory had not previously been applied in a detailed manner to the lending discrimination problem, and that the theory was in this respect underdeveloped. A large part of my argument in *Lending Discrimination* is an effort to flesh out the implications of the statistical discrimination theory.[22] The theory's implications depend greatly on the accuracy of race (or whatever statistic the economically advantaged party uses) as a predictor and on the cost of gathering information.

The second article, *The Community Reinvestment Act: Questionable Premises and Perverse Incentives* (*Perverse Incentives*), is an exploration of the costs generated by the statute.[23] I did not put serious effort into reexamining the social-benefit question, as I had already done so in *Lending Discrimination*. I thought it was worthwhile to examine the costs question because previous treatments had focused largely on the paperwork and other direct compliance costs imposed on banks.

The costs of the CRA, in addition to compliance costs, include undesirable incentive effects created by the statute. Some undesirable incentive effects are well known and have been discussed in

19. Hylton & Rougeau, *Lending Discrimination*, *supra* note 4, at 247-50.
20. *Id.* at 250.
21. *Id.* at 247-50.
22. *Id.* at 247-50, 253-62.
23. *Id.* at 250.

the previous literature.[24] For example, the fact that the statute's burdens would discourage banks from entering markets in which compliance could be costly has been noted in previous articles.[25] Because of this incentive, lenders that already serve distressed inner-city communities will face less competition, and will therefore be able to charge higher rates to their customers, creating evidence of the underinvestment and price discrimination that the statute aims to reverse.

Perverse Incentives identifies a few more costs. One is "inadequate incentives"; that is, the failure to offer incentives to a large set of banks and lenders.[26] Of course, this is a cost only to the extent that it represents a welfare loss relative to a regime in which the statute provides optimal incentives. Specifically, banks that did not have expansion plans probably had little incentive to invest effort in compliance. There is empirical evidence that banks that intend to expand try harder to comply with the statute.[27] The converse would seem to be implied by the same evidence: banks that are not intending to expand have weak incentives to invest in CRA compliance.

Another cost is the incentive to adopt "socially undesirable compliance stratagems": compliance in a manner that meets regulatory tests but imposes substantial external costs.[28] For example, suppose a bank participates with or finances the work of a predatory lender, in part to satisfy investment requirements of the statute. Although there is no solid empirical evidence of this, there is some evidence[29] and a disturbingly clear incentive for predatory lenders to take advantage of the incentives created by the statute.

Another category of costs falls under the heading of "rent seeking costs."[30] Mergers create rents or destroy rents. For example, take the case of a merger that will enhance competition in a

24. *See* Macey & Miller, *supra* note 14, at 295-96.

25. Hylton & Rougeau, *Perverse Incentives*, *supra* note 4, at 187 n.100 (citing Macey & Miller, *supra* note 14, at 340; White, *supra* note 12, at 287).

26. *Id.* at 183-87.

27. Raphael Bostic et al., *Regulatory Incentives and Consolidation: The Case of Commercial Bank Mergers and the Community Reinvestment Act*, 5, no.1 ADVANCES IN ECON. ANALYSIS & POL'Y, art. 2 (2005), *available at* http://www.bepress.com/bejeap/advances/vol5/iss1/art2.

28. Hylton & Rougeau, *Perverse Incentives*, *supra* note 4, at 184-86.

29. Kathleen C. Engel & Patricia A. McCoy, *The CRA Implications of Predatory Lending*, 29 FORDHAM URB. L.J. 1571 (2002); *see also* Hylton & Rougeau, *Perverse Incentives*, *supra* note 4, at 185-86 (discussing the allegedly predatory lending actions of Fleet Financial Bank of Boston, Massachusetts).

30. Hylton & Rougeau, *Perverse Incentives*, *supra* note 4, at 187-89.

local banking market. Such a merger would destroy oligopolistic rents, profits that exist because of the weakness of local competition, earned by incumbent banks. The larger those oligopolistic rents, the more the incumbent market competitors have an incentive to seek to block the proposed merger. The CRA provides a process by which local competitors can delay or potentially block the merger. Since the oligopolistic rents could be substantial, the local competitors may be willing to invest considerable sums in the regulatory process.

"Transaction costs" are another set of costs created by the statute.[31] The statute increases the cost of any merger among regulated entities. A merger is a financial transaction, a contract between two firms. The costs of regulatory compliance become part of the transaction costs of carrying out a merger.[32] Moreover, the transaction costs imposed on the acquiring party create a differential between the merger price agreed between the merging parties and the total price paid by the acquiring firm.[33] Since the amounts invested into the CRA approval process will be forfeited if the merger is not accomplished, the additional transaction costs provide incentives to merger targets and third parties to ramp up their demands during the course of the merger process.[34]

There may be other costs that I have not considered, but my point is straightforward: once we have identified a list of substantial costs created by the statute, the question whether the incremental benefits of the statute exceed its incremental costs becomes somewhat clearer. An empirical effort to determine whether the statute is worthwhile requires, in order to be rigorous, more than an examination of statistics on mortgage lending. A rigorous effort to determine whether the statute is socially desirable as currently enforced would compare the sum of the estimated incremental benefits with the sum of the estimated incremental costs.

My third article, *Banks and Inner Cities: Market and Regulatory Obstacles to Development Lending* (*Banks and Inner Cities*), reflects an effort to return to the market failure question explored earlier in *Lending Discrimination*.[35] Rather than treating discrimination as the essential market failure, I focused on asymmetric in-

31. *Id.* at 189-90.
32. *Id.*
33. *See id.* at 190.
34. *Id.*
35. Hylton, *Banks and Inner Cities*, *supra* note 4.

formation, which struck me as a more plausible account of market failure.[36]

The reasons for focusing on asymmetric information are detailed in the article, but the core reason is that the discrimination hypothesis finds little support in the data today, and yet the problem of underinvestment remains.[37] The most likely account for market failure is the "asymmetric-information/credit rationing" hypothesis explored in the economic-development literature.[38] I applied that hypothesis to the market for urban development lending.[39] Much of the analysis in *Banks and Inner Cities* is an effort to elaborate on the credit rationing theory in the context of urban lending markets.

I concluded that the CRA, in conjunction with other banking regulations (especially safety and soundness), should be viewed as an obstacle to development finance.[40] The core reason is a fundamental mismatch in compliance costs. The statutory framework is designed in a way that imposes the greatest compliance costs on "small, community development-oriented bank[s]."[41] Large banks find the compliance costs relatively small and have strong incentives to obtain high compliance grades under the statute in order to facilitate future expansion plans.[42] The mismatch problem is that it is primarily within small, community-development-oriented banks where we find individuals who have the most information and the greatest incentives to finance productive community-development efforts.[43] Banking-sector regulation serves to obstruct the develop-

36. *Id.* at 199.

37. *Id.* at 206-08, 222-23.

38. *See, e.g.*, Joseph E. Stiglitz & Andrew Weiss, *Credit Rationing in Markets with Imperfect Information*, 71 AM. ECON. REV. 393, 409 (1981).

39. Hylton, *Banks and Inner Cities*, *supra* note 4, at 223-29.

40. *Id.* at 229-33.

41. *Id.* at 234.

42. *Id.* at 229-36.

43. *See, e.g.*, W. Scott Frame et al., *Credit Scoring and the Availability of Small Business Lending in Low- and Moderate-Income Areas*, 39 FIN. REV. 35, 54 (2004) (credit scoring reduces informational asymmetry and expands lending by large banks to small businesses); Allen N. Berger et al., *Further Evidence on the Link Between Finance and Growth: An International Analysis of Community Banking and Economic Performance* (FEDS, Working Paper No. 2003-47, 2003; Bank of Finland, Discussion Paper No. 8, 2004; World Bank Pol'y Research, Working Paper No. 3105, 2004), *available at* http://ssrn.com/abstract=427780; Allen N. Berger et al., *The Ability of Banks to Lend to Informationally Opaque Small Businesses* (World Bank Pol'y Research, Working Paper No. 2656, 2001), *available at* http://ssrn.com/abstract=260575 (suggesting that small relationship-banks have an advantage in lending to opaque small businesses); James A. Brickley et al., *Boundaries of the Firm: Evidence from the Banking Industry* (Simon

ment and expansion of community-development-oriented institutions.[44]

Banks and Inner Cities suggests that empirical work on the quantity of loans may be inadequate to answer the question whether the CRA's benefits exceed its costs.[45] Whenever one examines a regulatory regime, there is always the question of deadweight loss, which is the difference between the outcome under the statute and what would be observed in the optimal feasible regulatory regime. In an optimally regulated regime, the fundamental mismatch observed under the current system would not be observed. The likely consequence is that community-development-oriented banks would expand relative to their competitors, and would support a strong entrepreneurial foundation for growth within cities.

II. A Brief Response to Critics

As I have suggested already, there is now a school of "critics of critics" who appear to assert that the CRA is essentially without flaws.[46] Their work focuses almost entirely on recent empirical studies of lending and does not provide a new or alternative theoretical approach to that offered in the first wave of law-and-economics analyses that were critical of the statute.[47] Indeed, it

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Sch. of Bus., Bradley Pol'y Research Ctr., Fin. Research Pol'y Working Paper No. FR 00-01, 2003), *available at* http://ssrn.com/abstract=204728 (supporting a hypothesis that small local banks have advantages over large banks); David A. Carter et al., *Do Small Banks Have an Advantage in Lending? An Examination of Small Business Lending Performance for Large and Small Banks* (2002), *available at* http://ssrn.com/abstract=297007 (presenting evidence that small banks have an advantage in small business lending); George R.G. Clarke et al., *Does Foreign Bank Penetration Reduce Access to Credit in Developing Countries? Evidence from Asking Borrowers* (World Bank Pol'y Research, Working Paper No. 2716, 2001), *available at* http://ssrn.com/abstract=285767 (indicating that although foreign bank penetration increases competition, benefits go primarily to large firms; suggesting small firms are still best served by local lenders); Ben R. Craig & James B. Thomson, *Federal Home Loan Bank Lending To Community Banks: Are Targeted Subsidies Necessary?* (Fed. Res. Bank of Cleveland, Working Paper No. 01-12, 2001), *available at* http://ssrn.com/abstract=282410 (suggesting that information, rather than funding, is important factor). For a recent discussion of related issues in law-and-development context, see generally Rashmi Dyal-Chand, *Reflection in a Distant Mirror: Why The West Has Misperceived the Grameen Bank's Vision of Microcredit*, 41 Stan. J. Int'l L. 217 (2005).

44. Hylton, *Banks and Inner Cities*, *supra* note 4, at 235.

45. *Id.* at 234-41.

46. Immergluck, *supra* note 5; Barr, *supra* note 5.

47. *See, e.g.*, Robert E. Litan et al., The Community Reinvestment Act After Financial Modernization: A Final Report (U.S. Treasury Dep't 2001) (providing findings regarding the effect of financial modernization legislation on the

appears that the new critics have entirely avoided an effort to grapple with the question posed in the first wave of writing: Are the incremental benefits of the CRA greater than its incremental costs? Or, one might put the question at a simpler level: What are the incremental benefits of the CRA and what are its incremental costs? The empirical literature has not attempted to answer these questions.

This is not the place to go into a detailed discussion of empirical results. I examined the results in some detail in *Lending Discrimination*, with a focus on yielding general hypotheses to be tested by future analysts.[48] The new critics have not, from what I can tell, attempted to frame a new or improved set of hypotheses for themselves or for future analysts. They have limited themselves to reporting the results of empirical research that appears to agree with their conclusions (and sometimes disputing the research that disagrees).

The new researchers have not addressed the mismatch issue raised in *Banks and Inner Cities*.[49] There is a fundamental set of questions about the philosophy of development and about its practice and effect. Should we be satisfied with a regime in which, when working at its best, large banks cross-subsidize lending in distressed communities to an extent that the total amount of lending increases relative to what would be observed in the absence of their cross-subsidization efforts; or should we prefer a regime in which entre-

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CRA); Robert B. Avery et al., *CRA Special Lending Programs*, 86 FED. RES. BULL. 711, 731 (2000) (finding that three-quarters of surveyed institutions cited the CRA as a contributing factor to their mortgage and small-business lending programs); Raphael Bostic with Breck Robinson, *Do CRA Agreements Increase Lending Patterns?*, 31 REAL EST. ECON. 23, 43-44 (2003) (demonstrating that CRA agreements influenced lending decisions even after the end of agreements); Bostic et al., *supra* note 27 (showing that banks with expansion plans expanded their lending relative to other institutions); Raphael W. Bostic & Brian J. Surette, *Have the Doors Opened Wider? Trends in Homeownership by Race and Income* (FEDS, Working Paper No. 00-31, 2000), *available at* http://ssrn.com/abstract=235864 (suggesting that regulatory statutes and economic factors have led to an increase in home ownership among lower-income families). These excellent empirical studies, often cited to support the claim that the CRA has improved lending in distressed communities, raise three questions. First, to what extent are observed lending increases due to the CRA or other factors? Second, are the incremental benefits of CRA-induced lending greater than the costs? Third, does the statute discourage other approaches that might be more productive? For an empirical article reaching negative conclusions on the effects of the CRA, see Jeffery W. Gunther et al., *Redlining or Red Herring?*, SW. ECON., May/June 1999, at 8, *available at* http://www.dallasfed.org/research/swe/1999/swe9903.pdf.

48. Hylton & Rougeau, *Lending Discrimination*, *supra* note 4, at 268-79.

49. *See supra* notes 35-45 and accompanying text.

preneurs in distressed communities find ready access to lenders who can help them form productive, job-creating areas of enterprise within these communities?

The existing regulatory regime, though it is coming under pressure to change from the current administration,[50] smacks of a top-down development plan in which large financial institutions make the fundamental decisions on the allocation of credit while responding to pleas and demands for help from various sectors. Within economically distressed communities, the parties that can raise the clearest threat of blocking future expansion plans are the ones most likely to catch the attention of the banks. This plan allows some of the lending that finds its way into distressed communities to be diverted from economically productive endeavors towards politically influential interest groups.[51]

The alternative vision would stress entrepreneurship as the base for community development and attempt to build around that notion.[52] It would minimize the discretionary power of government officials and the influence of pressure groups in the allocation of credit.

III. Going Forward: Principles for Legislative Reform

Based on my earlier work, and from what I have seen of the new wave of writing, I think there are three key planks that should form part of a community-development finance program, or any legislation for that purpose. The three planks are: the enhancement of public goods, the subsidization of development efforts, and the reduction of regulatory obstacles.

50. *See* Strengthening America's Communities Advisory Committee, Report of the Strengthening America's Communities Advisory Committee (2005), *available at* http://www.eda.gov/PDF/EDAmericaSummer05.pdf (stressing entrepreneurship model as alternative to existing community development programs sponsored by the federal government).

51. On the harmful effects of politically directed credit allocation, see, e.g., Eduardo Levy-Yeyati et al., *State-Owned Banks: Do They Promote or Depress Financial Development and Economic Growth?* (2004) (unpublished paper, *available at* http://ssrn.com/abstract=629384); Joe Peek & Eric S. Rosengren, *Unnatural Selection: Perverse Incentives and the Misallocation of Credit in Japan* (Nat'l Bureau of Econ. Research, Working Paper No. 9643, 2003), *available at* http://www.nber.org/papers/w9643.

52. J. David Brown et al., *What Makes Small Firms Grow? Finance, Human Capital, Technical Assistance, and the Business Environment in Romania* (Inst. for the Study of Labor (IZA), Discussion Paper No. 1343, 2004; Upjohn Inst. Staff, Working Paper No. 03-94, 2004), *available at* http://ssrn.com/abstract=425421 (concluding that access to finance matters most in growth of small firms).

A. *Enhancement of Public Goods*

The most basic public good that a government can provide is security. And yet security is clearly inadequate in many of the distressed cities. The causes are numerous: the lack of family cohesion, the failure of the education system, and the perverse effects of drug prohibition are some of the most important.

Security is such an important public good that I doubt that it makes sense to talk about community-development finance in its absence. Families and businesses will not move into areas in which crime is a high and constant risk. Deserted streets invite criminals to take them over. It is highly unlikely that any bank could, through lending efforts, reverse the small-scale economic depressions created by the lack of security in many cities.

On the other hand, if you take care of security, you will find that businesses and city residents will often be willing to take care of the rest of the development project on their own. Some families are willing to move into areas with weak schools as long as the streets are safe; they can form private schools if necessary. Some businesses are willing to move into areas with undereducated labor forces as long as their businesses are safe; they can train their employees or hire workers from elsewhere if necessary. And when families and businesses are bidding to move into an area of a city, lending institutions will soon follow them.

Admittedly, security is expensive, but the alternative, absence of security, is more expensive. The most important community development project that can be undertaken is the provision of security to homes and businesses. It follows that a revenue-strapped municipal government should seek to pare all of its costs except for security. Until security reaches a stage within cities such that it is adequate for businesses and families to operate without substantially more risk than experienced in suburban communities, local tax revenues should be devoted primarily to security.

Obviously, education is also a priority. However, education can often be funded privately because each recipient of education obtains a valuable benefit. That is why people pay for private schools. Security, on the other hand, is a benefit that is so broadly shared that few people are willing to pay substantial amounts for it (beyond purchasing an alarm system), especially when there is the option of moving to a secure location. Because the benefits of security are so broadly dispersed and cannot be captured by any individual, it is perhaps the most basic of public goods.

Housing values are largely influenced by public goods such as security and education. This is obvious if you simply compare the values of comparable houses in Detroit and in Boston. Detroit is a city that has a high crime rate and a poor education system. Boston has, in comparison, a relatively low crime rate—even in its worst areas, crime is still mild in comparison to Detroit—and a decent educational system. If you take a house from Detroit and move it to Boston, you would probably triple its value.

B. *Subsidization of Development Efforts*

In addition to focusing on security as the foundation of any community-development plan, statutory regimes to enhance community-development finance should focus on subsidization rather than punishing firms under a one-size-fits-all regulatory structure. This is true for several reasons.

First, as I stressed in *Lending Discrimination*, you can achieve the same incentives with a carrot as you can with a stick.[53] Incentives to do any act depend on the payoff for doing the act relative to the payoff for not doing it. You increase the incentive to do an act by widening the spread between these two payoffs. A penalty widens this gap by imposing a cost for not doing the act. A subsidy widens the gap by providing a reward for doing the act.

Sometimes a subsidy is preferable to a penalty. In general, when we want to see the provision of a public good, or a benefit to society, we should subsidize the act. This is the basic distinction found by John Stuart Mill between acts that harm others and acts that provide a benefit to society. Mill argued that punishment should be restricted to the first set of acts.[54] It follows from this view that if we want to see people pick up trash on the streets, we should subsidize it. The alternative is to punish them for failing to pick up trash, but it should be clear that this would have undesirable incentive effects.

The subsidy provides a positive incentive and does not tax people for merely falling under the scope of the regulation. When we are considering a productive industry such as lending, we should be reluctant to pass laws that tax the general activity of lending, unless there is evidence that it is in fact socially harmful. Given this, laws that seek to target lending in a direction not already induced by the

53. Hylton & Rougeau, *Lending Discrimination*, *supra* note 4, at 282-86 (describing a shift from a penalty approach to a subsidization approach).

54. JOHN STUART MILL, ON LIBERTY 92-94 (Oxford Univ. Press 1960) (1859).

market should attempt to do so through "bribing" rather than punishment.

In general, one can distinguish between substitution and scale effects in regulation. Regulatory penalties induce a substitution toward a desirable act to the extent that they make that desirable act less costly than others. However, regulatory penalties can reduce the level of desirable acts through scale effects, which discourage parties from coming within the scope of the regulation in the first place.

These broad suggestions obviously apply to the CRA. As I suggested in *Perverse Incentives*, the statute and its enforcement should be redirected toward positive rewards. Banks that engage substantially in the community-development process should be rewarded with lighter regulatory burdens or tax benefits. This avoids the often-observed conflict between substitution and scale effects in regulation.

Indeed, there is a startlingly simple and potentially effective subsidization policy that presumably would not require modification of federal law: Individual cities can enhance economic-development efforts by using the development-lending records of banks as a basis for determining the amounts held by each as a municipal depository. American cities put enormous sums in accounts held by municipal depositories. If city mayors were to shift those accounts toward small, development-oriented banks, it would provide a powerful spur for banks to expand finance in economically distressed communities. Alternatively, one could envision a system in which an independent body graded banks according to their economic-development efforts within cities and private corporations voluntarily directed accounts to banks on the basis of their success in these efforts.

C. *Reduction of Regulatory Obstacles*

The third general plank in a sound community-development finance program is the reduction of regulatory obstacles. Around the world, there are many existing regulatory obstacles to development lending. Legal systems sometimes inhibit finance by making it difficult to enforce contracts or to use property as security for loans.[55] Some prohibit interest charges above a ceiling rate and, in Islamic

55. *A Survey of Microfinance: The Hidden Wealth of the Poor*, ECONOMIST, Nov. 5, 2005, at 3-4.

countries, even the charging of interest at all.[56] Some governments control banks and direct their lending.[57] Poor monetary policy leads to inflation, which reduces the scope of financial markets.[58]

Observing some of the stricter forms of regulation in other countries, we may be inclined to view our own system as free of regulatory obstacles. But regulatory obstacles can take many forms. Regulatory laws often benefit one set of firms and disadvantage another set. When this occurs, the firms that benefit gain an incentive to support the law, which may have an anticompetitive consequence. If the losing firms are the ones that are most likely to engage in development lending, then the law, whatever its purpose, can be said to serve as a regulatory impediment to development lending.

We should have an eye out for laws that serve as obstacles to development finance. In many cases, this will mean taking a skeptical view of many banking regulations because the dominant faction within the larger interest group of banks are the big banks that do not view development lending as core to their mission. The statute-making process will not, as a general rule, favor or protect the business of development-oriented lenders.

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56. *Id.* at 3.
57. *Id.* at 4.
58. *Id.*