Over the past two decades, venture capital, defined as at-risk equity investment provided by investors to privately held companies with perceived long-term growth potential, has been one of the major drivers of the U.S. economy. As a source of financing for early stage companies, venture capital investors make high-risk, high-reward investments that support high growth companies and foster innovation. Companies that received venture funding between 1970 and 2003 accounted for 10.1 million jobs in 2003.¹

Venture capital investment is unevenly distributed: fully two-thirds of U.S. venture capital investment takes place in five concentrated geographic areas (Silicon Valley, New England—primarily metro Boston, metro New York, Texas, and Los Angeles/Orange County).

The venture capital industry has organized itself to maximize profits by focusing on a select group of high growth industries and on specific geographies. As a result, the benefits of venture capital investment are unevenly distributed: fully two-thirds of U.S. venture capital investment takes place in five concentrated geographic areas (Silicon Valley, New England—primarily metro Boston, metro New York, Texas, and Los Angeles/Orange County), and the economic areas of the Silicon Valley and metro Boston account for nearly one-half of all investment. Given this geographic concentration of investment, an important question to ask is, why do some investors choose to invest outside of these five areas? This article examines venture capital investment in secondary cities, cities outside of the 40 largest U.S. metropolitan statistical...
areas (MSAs), and takes a detailed look at investment in New England secondary cities. We identify factors that may explain how certain smaller cities attract venture capital and make recommendations about how secondary cities can design policies aimed at increasing the flow of this type of capital to their industries.

Background
Venture-backed companies play an important role in economic development. While it remains a challenge to determine the direct effects of venture capital investment on firm behavior, it is clear that venture-backed firms are more innovative and grow more quickly than others. One study found that venture capital is three to four times more effective in stimulating patent activity, a critical measure of innovation, than the equivalent amount of traditional R&D spending. This suggests that venture capital, while averaging less than 3 percent of corporate R&D, accounts for about 10 percent of U.S. innovation. There is also compelling evidence of the positive effect of venture capital on a company’s revenues and earnings. Anecdotally, many large and successful New England firms were venture-backed, from software firms like voice-over-Internet specialist Sonus to national retailers like Staples.

However, secondary cities have received far less than their proportionate share of private equity deals and dollars. The figures we cite below come from our study conducted with the Initiative for a Competitive Inner City (ICIC), which uses data from ICIC’s State of the Inner City Economies database and covers the time period of January 2003 to August 2005. According to our analysis, secondary cities received 13 percent of all deals and 20 percent of total investment dollars, despite the fact that secondary cities accounted for 51 percent of the U.S. population, 49 percent of the number of business establishments, and 38 percent of the U.S. payroll.

In the six New England states, the disparity between population and establishment share in secondary cities compared with the total investment dollars they receive becomes even more pronounced. The region’s secondary cities, or those cities located outside of metropolitan Boston, account for 68 percent of the population of New England, 69 percent of the business establishments, and 58 percent of the payroll. During the study period, however, they received only 22 percent of all deals and 23 percent of total investment dollars.

By failing to attract capital at similar rates to larger cities, secondary cities are missing a major engine of job and wage growth. Not all secondary cities are the same, however. A number of these cities have managed to assemble the right combination of factors to significantly outperform their peers in terms of the amount of venture capital they have been able to attract. Clearly, metro Boston has attracted far more venture investment than the rest of New England. Yet, New England has some particularly successful secondary cities, with eight of the top 20 high-performing secondary cities (measured in terms of the investment they have been able to attract) located in the region. Figure 1 shows these 20 cities. New England cities are shown in black.

Investigating Success in Certain Secondary Cities
There are myriad potential explanations for high performance by some secondary cities. To understand the drivers of venture capital and private equity investment in secondary cities across the country, we interviewed the leaders of 17 venture firms, including national and regional firms representing more than one-half of the top 10 investors in secondary city markets. We also interviewed and surveyed 53 companies in secondary city markets that successfully received venture capital investment funds as well as industry experts and venture funding facilitators. From these interviews and surveys, we identified six factors that industry representatives cited as having helped secondary cities attract more venture capital than their peers.

1. Clusters and Networks
The most valuable factor involves connections. First, connections between firms are important. These company-based links are exhibited by industry clus-
ters, which are defined as “geographic concentrations of interconnected companies, specialized suppliers, service providers, and associated institutions in a particular field.” Secondary cities that are able to attract the most venture capital benefit from holding a high concentration of a particular cluster, i.e., a higher share of jobs in that cluster out of total jobs in the city compared with the share of jobs in that cluster for the United States as a whole.

Second, smaller cities that attract venture capital have strong connections among individuals within the industries. Often these personal networks are organized by professional societies and are part of well-functioning clusters. They are critical to securing equity capital investments: both venture capital firms and companies report that networking is the dominant channel they use for identifying potential deals. Conversely, the heavy reliance on personal networks exacerbates the challenges for cities that lack clusters to support the formation of such networks.

Figure 2 shows the high-concentration clusters present in the eight New England cities listed in Figure 1. These cities have some clusters that are especially attractive to venture capitalists. In particular, we see clusters that have traditionally received large shares of deals in such fields as biopharmaceuticals and medical devices (Norwalk CT), information technology (southern New Hampshire), communications technology (Stamford CT), and business services (Southborough and Westborough MA).

In some cases, there are clusters that did not receive venture investment during the study period but may be associated with other clusters that did receive such capital. For example, one cluster that does not traditionally receive venture capital was nonetheless present in half of New England’s high-performing secondary cities: Education and knowledge creation was over-represented compared with the United States as a whole in four high-performing New England secondary cities, and was well represented in two additional cities. The strong presence of institutions of higher education in New England is likely associated with another of the factors that our research identified as important in attracting venture capital: intellectual capital and technology transfer (described below).
2. Investor Presence
Another important factor in attracting venture capital to secondary cities is an already established investor presence. Some firms investing in secondary cities specialize in these markets. In other cases, firms investing in secondary cities are national or international firms that allot a small portion of their funds to these markets.

Angel investors are an important part of the funding cycle for many entrepreneurs. For rapidly growing firms, repeated capital infusions are often necessary to bridge the gap between an entrepreneur using personal resources and the time when a firm can attract venture capital financing. These funds are critical to many secondary-city companies (our research found that nearly half of the companies receiving private equity had received prior angel funding) and may also take the place of some early-stage venture investors in some locations. However, angels have a mixed reputation among venture capital investors because of their varying levels of expertise in finance. There is a growing movement to professionalized angels and angel groups – a movement that has the potential to significantly improve capital access in secondary cities.

3. Historical Returns
Capital flows to markets where it can attract reasonable returns. One of the factors negatively impacting the ability of secondary markets to attract venture capital investment is the perception that the return on venture capital investment in these markets has been below average.

4. Intellectual Capital and Technology Transfer
Our research found a significant correlation between deal flow in secondary cities and the presence of national research universities. Technology transfer from universities can be a major engine of innovation and firm formation. Our study also showed a close link between deal flow in secondary cities and the share of jobs that require high levels of education.

5. Community Attractiveness
Our research identified a strong correlation between the ability of communities to successfully attract venture capital and the quality of life in these communities. It appears that this correlation has to do with both ease of recruiting high-level technical and management expertise to attractive communities and the propensity for such highly mobile talent to have already migrated to such places.

6. Accessibility
The presence of direct transportation access from major funding centers is an important factor for attracting venture capital. Venture capital firms dislike investing in companies in remote locations because of the difficulty of finding and vetting deals in these locations, the higher cost of having staff from the venture firm or other experts serve as company board members and mentors, and concerns about the ability to attract management talent to remote areas. This is particularly true for early stage investments, which typically require more intensive hands-on involvement from venture capital firms.

The six factors described above comprise the “secret sauce” that enables some cities to be successful in their attempts to attract venture capital. Moreover, these factors may be some of what draws the entrepreneurial firms that ultimately attract the venture capital. New England secondary cities boast several advantages over their peers in attracting venture capital – strong local clusters, proximity to Boston, which has one of the country’s highest concentrations of venture capital and private equity firms, access to significant intellectual capital from the region’s universities, and a trained workforce. The challenge for the region is to leverage these assets to create fertile ground for entrepreneurial firms and their investors.

Opportunities
In New England and nationally, there is no one-size-fits-all approach to improving capital flow to secondary cities. A city’s ability to utilize levers will depend on its size and unique mix of assets and liabilities. For example, some cities may have less potential as locations for venture capital investment because of their geographic isolation or the limited presence of research universities, but may still be able to encourage capital flow by organizing angel networks. Others will have to develop long-term plans to improve education/workforce development and quality-of-life assets so that they can attract and nurture growing firms. There will also be some communities that have either such significant scale barriers or so few natural assets that an economic development strategy based on encouraging entrepreneurship and attracting capital is not a productive use of resources.
There are likely, however, a number of secondary cities that can use policy levers to help attract venture capital. While the venture capital industry’s fast moving and entrepreneurial nature makes it challenging to use traditional economic development tools to encourage investment, a number of opportunities exist for policymakers, community leaders, and foundations to participate with high-potential secondary cities to improve their competitiveness in attracting private equity investors.

**Strengthen Clusters and Networks**

Given the role that clusters and networks play in firm formation and capital attraction, one approach secondary cities can take is to work with groups that help clusters grow and facilitate networking. To identify and strengthen clusters, cities can work with groups like ICIC’s City Advisory Practice, which helps communities develop strategies to increase competitiveness and remove barriers to growth for high-potential local business clusters. Cities can also work with organizations that foster networks, such as the MIT Enterprise Forum, the Wayne Brown Institute, and ICIC’s Inner City Economic Forum. These relationship-builders can play roles ranging from directly establishing networks to introducing entrepreneurs to potential capital sources. Industry associations and trade groups can also play a productive role in fostering networks.

There may also be an opportunity to build “virtual clusters” that are located in different geographic locations. Organizations can identify high-potential industries and connect promising companies in these industries from multiple locations, creating a pool of prospective investments for venture capital firms.

**Encourage a Continuum of Capital**

Our research identified that it is important for secondary cities to have a continuum of equity capital available, from angel financing through early and then later stage venture financing. It is true that many entrepreneurial firms secure capital from outside their regions, particularly in the later stages. However, during the initial period – when firms’ capital needs are modest, the relative transaction costs of traveling to seek capital are high, and companies require a lot of hands-on involvement from investors – the availability of angel capital is critical.

An opportunity exists in many secondary cities to encourage the development of angels’ expertise and the growth of angel groups. Support for the angel capital industry can take the form of providing training to angels, supplying operating support to angel groups, and making capital commitments alongside angel investors. Cities and organizations interested in supporting angel groups can also sponsor the use of web-based technology to bring education programs to angels in remote locations, to promote angel networks, and to inform and educate potential angel investors. Currently, the Ewing Marion Kauffman Foundation has taken a lead role in educating individuals to enable them to form angel groups nationwide. In addition, Rain Source Capital is working to develop angel groups in numerous mid-sized and rural communities.

**Increase Investment Levels**

One way to increase investment levels is to show that secondary cities have been good performers in terms of the rate of return on investments. In addition, those interested in promoting investment in sec-
Two firms with innovative approaches to providing venture capital are Village Ventures (Wilmington MA) and CEI Community Ventures (Portland ME). They differ from traditional funds by targeting their investment to companies located in areas that do not receive large amounts of venture capital.

**Affiliate model:** Village Ventures, founded in 2000, is a national firm that acts as a central office for a network of affiliates in predominantly smaller communities, centralizing fundraising assistance, co-investment, and back office services. Its goal is to fuel innovation in areas with high densities of intellectual capital that have been ignored by traditional capital markets. Its affiliated funds, including Worcester Capital Partners (Worcester MA), Long River Ventures (Hadley MA), and Fresh Tracks Capital (Middlebury VT) have invested a total of $150 million in 100 companies. Village Venture’s model gives smaller venture firms access to deep domain expertise and talent, professional services, capital, and a national brand, while leveraging the local expertise and deal-sourcing capabilities of its partners.

**Place-based model:** CEI Community Ventures, Inc. has used a different approach, directly funding small and medium-sized companies in lower income areas of Maine, New Hampshire, and Vermont. It invests in consumer and technology businesses, utilizing funds provided by the U.S. Small Business Administration and leveraged by private fundraising. CEI is innovative in its approach to identifying potential investments – it works with community partners to hold events such as introductory seminars on venture capital for emerging businesses. The company has also developed strong relationships with local businesses, economic development groups, and service providers to deepen its networks in the communities it targets. It provides no-cost operational assistance to help high potential businesses become equity ready. To date, CEI Community Ventures has invested in six growing businesses and has developed particular expertise in the natural/organic processed food and skin care industries.

Credit is an example of such an initiative, providing a tax credit for certain kinds of equity investments.

**Strengthen Intellectual Capital and Technology Transfer**

Governments, trade associations, and foundations can work with universities to strengthen the flow of universities’ technology to the business community, especially in key industry clusters. Higher education can also be tapped to provide the specialized training required of employees in regional industries.
Enhance Community Attractiveness and Accessibility

The ways in which local communities can improve the attractiveness of their locations are the same factors that contribute to sustainable economic development:

- improve the quality of education
- facilitate workforce training
- improve the quantity and quality of local amenities
- reduce government regulation to reduce operating costs
- support initiatives to improve the entrepreneurial environment, e.g., local venture groups, collaboration with universities

Communities with a commitment to attracting investment can also have as an objective of their transportation policies to make their location more accessible. A basic way to do this is to encourage more direct flights to the secondary city from key capital markets and to promote easier access to and from airports.

Conclusion

New England secondary cities are particularly well positioned to use venture capital to support economic development. Several boast strong clusters, proximity to the high concentration of venture capital firms in the Boston market, and access to technology transfer and intellectual capital from the region’s universities. There are also two new trends that may help increase the flow of venture capital to the region’s secondary cities. First, New England’s secondary cities are witnessing the emergence of angel groups, networks, and resources to support angel funding. And second, the region is home of some of the most innovative funding approaches to venture capital investment.

Private equity in general and venture capital specifically have proven to be among the fastest moving and most entrepreneurial of industries, and over the years, their impact on the economic landscape of New England communities has been significant. As the industry continues to grow and thrive, proactive planning based on an understanding of industry dynamics will enable New England secondary cities to continue to benefit from the job growth, company formation, and wealth creation fostered by venture capital and private equity investments.

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Notes


2 It is hard to disentangle whether this positive effect derives largely from innovative firms being more likely to choose venture financing or from whether the capital indeed spurs innovation and job growth.


5 Here, private equity refers to both venture capital (early through expansion stage venture capital) and non-venture private equity such as buyout, leveraged recapitalizations, and other later stage private financing. While this paper focuses primarily on venture capital, data on secondary city investment include both private equity categories. Angel capital refers to individuals or groups investing personal wealth in early stage ventures.

6 The population figure is from the Census 2000 conducted by the U.S. Census Bureau and uses the 2005 definition of MSAs. Data for business payroll and establishments are from the County Business Pattern series of the U.S. Census Bureau.

7 During the study period, there were 1,000 private equity deals in New England, accounting for $7.7 billion in venture capital investment.

New England Updates

By Ricardo Borgos

Fourth Quarter 2006

Across the Region

Ballot Measures
In the November 7 general elections, the New England electorate voted on a number of ballot measures with implications for community development. These are highlighted below. In particular, Maine voters rejected a cap on increases in state spending; New Hampshire voters chose to prohibit the use of eminent domain if the property is to be transferred to another private entity for private development; and Rhode Island voters turned down a proposal to permit a tribal casino but voted to allow the sale of $50 million in affordable housing bonds over the next four years.

New England Ballot Measures in November 2006 General Elections

<table>
<thead>
<tr>
<th>State</th>
<th>Question 1</th>
<th>Status: Fail (Yes votes: 45.6%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Maine</td>
<td>A bill to restrain the growth in state and local government by imposing expenditure limitations on state and local government and by requiring voter approval of tax and fee increases.</td>
<td></td>
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<tr>
<td>Question 2</td>
<td>Initiative Petition Deadlines</td>
<td>Status: Pass</td>
</tr>
<tr>
<td>Massachusetts</td>
<td>Sale of Wine by Food Stores</td>
<td>Status: Pass</td>
</tr>
<tr>
<td>Question 2</td>
<td>Nomination of Candidates for Public Office</td>
<td>Status: Fail</td>
</tr>
<tr>
<td>Question 3</td>
<td>Family Child Care Providers</td>
<td>Status: Fail</td>
</tr>
<tr>
<td>New Hampshire</td>
<td>Prohibits the use of eminent domain if the property is to be transferred to another private entity for private development.</td>
<td>Status: Pass</td>
</tr>
<tr>
<td>Question 2</td>
<td>Redistricting</td>
<td>Status: Pass</td>
</tr>
<tr>
<td>Rhode Island</td>
<td>Approval of the amendment to the Rhode Island constitution would authorize a resort casino in the town of West Warwick, to be privately owned and privately operated in association with the Narragansett Indian Tribe, with tax proceeds from the casino being dedicated to property-tax relief.</td>
<td>Status: Fail (Yes votes: 37.0%)</td>
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<tr>
<td>Question 2</td>
<td>Elections – Restoration of Voting Rights</td>
<td>Status: Pass</td>
</tr>
<tr>
<td>Question 3</td>
<td>Budget Reserve Account</td>
<td>Status: Pass</td>
</tr>
<tr>
<td>Question 4</td>
<td>Higher Education Bonds - $72,790,000</td>
<td>Status: Pass</td>
</tr>
<tr>
<td>Question 5</td>
<td>Transportation Bonds - $88,500,000</td>
<td>Status: Pass</td>
</tr>
<tr>
<td>Question 6</td>
<td>Roger Williams Park Zoo Bonds - $11,000,000</td>
<td>Status: Pass</td>
</tr>
<tr>
<td>Question 7</td>
<td>Fort Adams State Park Recreation and Restoration Bonds - $4,000,000</td>
<td>Status: Fail</td>
</tr>
<tr>
<td>Question 8</td>
<td>Department of Environmental Management Bonds - $3,000,000</td>
<td>Status: Pass</td>
</tr>
<tr>
<td>Question 9</td>
<td>Authority for the State of Rhode Island to issue general obligation bonds, refunding bonds, and temporary notes in an amount not to exceed $50 million for affordable housing.</td>
<td>Status: Pass (Yes votes: 66.0%)</td>
</tr>
</tbody>
</table>

Minimum Wage
Effective October 1, 2006, Maine raised its minimum wage from $6.50 an hour to $6.75 an hour. This minimum will increase again, to $7.00 an hour, on October 1, 2007. The minimum wage rates for New England states are: Connecticut: $7.40; Massachusetts: $6.75; Rhode Island: $7.10; Vermont: $7.25. New Hampshire is the only state in New England with the same minimum wage as the federal level, currently $5.15 per hour. Connecticut, Massachusetts, and Rhode Island’s minimum wages are all set to rise in January of 2007 to $7.65, $7.50, and $7.40, respectively. Vermont’s minimum wage increases every 12 months at the same rate as the Consumer Price Index. As a result, on January 1, 2007, Vermont’s minimum wage will increase from $7.25 to $7.53 per hour.

State Highlights

CT

Connecticut

In October, seven housing projects received a combined $6.6 million from the state’s Housing Trust Fund to create more affordable housing in Connecticut. The Housing Trust Fund is designed to help create and preserve housing for low- and moderate-income working families by providing critical gap financing in the form of loans and grants. This funding completes the first year’s allotment of $20 million from the five-year, $100 million fund.

In November, the North Walke Housing Corporation (North Walke) received a $1.1 million grant from the state Department of Economic and Community Development to initiate the Norwalk Homeownership Assistance Program. This program is part of Governor M. Jodi Rell’s initiative to combat sprawl by expanding housing opportunities in cities. The funds will help first-time home buyers in Norwalk afford down payments and closing costs. North Walke expects to begin accepting applications to the program beginning in January 2007. Interested applicants can learn more about the program by visiting http://www.norwalkct.org/ReDevelopment/NewRD/index.htm.

ME

Maine

In December, Maine joined a $14.5 million, 15-state settlement involving discount programs for home repairs and other services. Chase Bank USA, its subsidiary Chase Home Finance LLC, and Trilegiant Corporation allegedly offered free trial memberships to various discount programs without telling consumers that they would be automatically charged fees if they did not cancel the memberships within a certain time period. To cover civil penalties and recoup costs and fees, Trilegiant is paying the state of Maine $477,128, and Chase is paying $175,000.
Massachusetts

In October, Massachusetts launched a first new healthcare reform product: Commonwealth Care. An estimated 50,000 residents with incomes at or below 100 percent of the federal poverty level (FPL) are now eligible to apply for the program. Members get free or low cost health services through managed care health plans and can choose from several plans offered by private health insurance companies. By the end of January 2007, the state will notify applicants in the at or below 100 percent FPL group that they have been approved for coverage. Individuals who believe they are part of this group may call a Commonwealth Care customer service representative at 1-877-MA-ENROLL.

In December, Bank of America announced the introduction of its “America Block by Block” program in the city of Lawrence. Created to assist areas with concentrated poverty, the Block by Block program currently operates in Los Angeles, West Oakland, Washington DC, and Tampa Heights. The program in Lawrence will be delivered through five channels: real estate development, mortgage lending, family asset-building, small business development/technical assistance, and philanthropy/volunteerism. As part of the program, Bank of America announced a $40 million investment in the development of loft-style rental units at Washington Mill Lofts, with 10 percent of the units reserved for low-income families. In addition, Bank of America committed a minimum of $250,000 in philanthropic funding to Lawrence CommunityWorks and Groundwork Lawrence over the next five years.

New Hampshire

In December, the University of New Hampshire’s Carsey Institute announced that it had received a $1 million grant from the W. K. Kellogg Foundation to support the work of its Center for Rural Families and Communities. The grant will support the institute in producing reports and policy briefs on issues of concern to rural communities and in building knowledge of changing conditions in natural resource-dependent communities. The Carsey Institute also announced that it will work with the W.K. Kellogg and Annie E. Casey foundations, the Center for Rural Strategies, Rural LISC, and others to identify key, timely issues where good analysis and effective dissemination of information can make a positive difference in policy debates.

In December, TD Banknorth New Hampshire presented the New Hampshire Main Street Center with a $100,000 investment through the Community Development Finance Authority’s tax credit program. The money will fund the Center’s specialized training for all communities statewide and will fund technical assistance visits to the 20 Main Street communities throughout the state. The New Hampshire Main Street Center helps communities strengthen their downtowns by focusing on historic preservation and public-private partnerships to build local pride.
Rhode Island

In the November general elections, Rhode Island voters approved Question 9, a ballot measure calling for the sale of $50 million in affordable housing bonds. Approval of Question 9 will allow the Housing Resources Commission to allocate $12.5 million annually for the next four years to fund the best proposals for building new homes and converting abandoned houses, mills, and other buildings into housing. The $50 million is expected to generate an additional $450 million in funding from private investors, the federal government, and other sources, adding up to over 1,000 more houses and apartments for Rhode Islanders. The Vote Yes on 9 campaign was sponsored by HousingWorks RI, a coalition of more than 120 organizations working to promote affordable housing in Rhode Island.

A state plan to end homelessness developed by members of Governor Don Carcieri’s administration, in cooperation with several state agencies and advocates for the homeless, and approved by U.S. Department of Housing and Urban Development, was released in December. The plan calls for creating hundreds of additional housing units, taking steps to prevent people from becoming homeless, and establishing the political will to end homelessness. The state’s other priorities as specified in the plan include the phase-out of large shelters in favor of smaller ones, using data to show the benefits of ending homelessness, and creating a coordinated service system for those without a permanent place to live.

Vermont

In October, Vermont presented seven ceremonial checks totaling more than $400,000 from the U.S. Department of Agriculture Value Added Producer Grant (VAPG) program to farmers and groups that support farming. The VAPG program was created to help eligible farmers, farmer groups, and farmer cooperatives establish a value-added marketing opportunity for an agriculture product. The Vermont Housing and Conservation Board received a $200,000 grant to continue its assistance to farmers involved in the Vermont Farm Viability Program and the Northeast Organic Farming Association of Vermont received a $50,000 grant to provide intensive technical assistance to start-up Island Pond farmers’ markets and general marketing and development support to 28 other farmers’ markets across rural Vermont.

In November, the federal Environmental Protection Agency (EPA) gave the city of Winooski a national award for Winooski’s downtown building boom, the return of a historic street layout, and the RiverWalk, a promenade on the banks of the Winooski River. The EPA created the National Award for Smart Growth Achievement in 2002 to recognize outstanding approaches to development that benefit the economy, the community, public health, and the environment.
We would like to thank Ann Eggleston for her editorial assistance.

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