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A New Rural Economy: A New Role for Public Policy

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There is good news and bad news for the rural economy. Over the past couple of years, fortunes have turned up as the rural economy has outpaced the metro economy. Looking deeper, though, reveals long-term structural shifts which underscore ongoing concerns whether rural regions will be able to compete as effectively in the 21st century. These shifts also raise fresh questions whether rural development policy crafted for an earlier era offers the greatest promise in helping rural regions in their new economic quest.

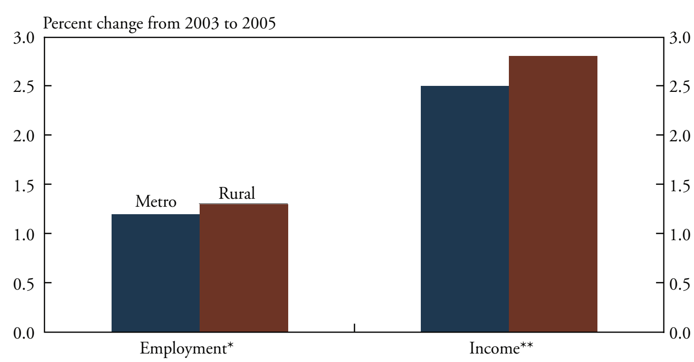
Recent trends in the rural economy

The rural economy has enjoyed a strong upturn since 2003. Growth in income and jobs has been stronger in rural America than in metro areas (Chart 1).[1] In '04 and '05, rural incomes grew 2.8 percent a year (vs. 2.5 percent in metro areas). Jobs were added at a 1.3 percent annual pace (1.2 percent in metro areas).

The rural growth appears broad-based, though clearly paced by growth in high-skill jobs and new activity in recreational areas. Rural service jobs have been growing briskly, especially in high-skill and recreation-related categories. For instance, finance, professional, and business service jobs grew 3.2 percent annually over the past two years. These gains are especially welcome in rural areas since they represent top paying jobs and help retain highly trained professionals in rural communities. Meanwhile, job growth in recreational industries rose 2.7 percent.

The rural upturn has also been supported by a leveling out in rural manufacturing. The most recent recession spawned a significant blood-letting of rural factory jobs, but that appears to have been staunched more recently. Rural factory closures are now about half what they were in '01 and '02.[2] And rural factory jobs have edged up 0.7 percent a year in '04 and '05, after contracting nearly a fifth from 2000 through 2003.

Chart 1
U.S. Employment and Income Growth by Metro and Rural (Nonmetro) Areas



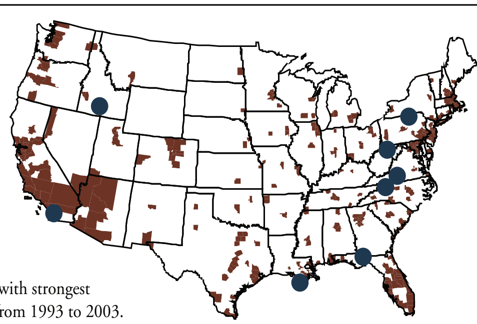
* Calculations based on Current Employment Statistics (CES) data from the Census Bureau.
** Calculations based on weekly earnings data, Current Population Survey (CPS) Bureau of Labor Statistics.

The recent upswing has been helped along by record farm incomes. On the strength of big crops and strong livestock profits, farm incomes were at an all-time high in '04 and second best in '05.[3]

Recent rural economic gains are certainly welcome, but they can mask persistent long-term economic challenges. Historically, rural America has depended heavily on commodity agriculture, natural resource extraction, and labor-intensive manufacturing. Globalization challenges all three—forcing U.S. producers to slash costs to stay competitive. Thus a pattern of consolidation is the norm throughout the countryside. Farms get bigger and fewer. Coal mines in Wyoming's Powder River Basin produce more coal with bigger shovels and trucks, but fewer workers. Taken together, these shifts mean fewer and fewer rural communities can tie their economic future to the economic engines of the past.

Building new economic engines is not easy, however. A longer term perspective suggests that rural areas are struggling more than metro areas in meeting this challenge. Since 1993, employment gains in rural areas have lagged behind those in metro areas (Map 1). This suggests metro areas have been more successful in shifting to leading edge industries. A look at the leading edge of growth raises even more concerns about rural areas. There are about 3,100 counties in the United States. The top 10 percent of those counties have contributed nearly three-fourths of the nation's new jobs since 1993. And only 8 of those 310 counties are in rural America.

Map 1
Top 10 percent of Counties with Strongest Employment Growth—1993 to 2003



Calculations based on Regional Economic Information System data from the Bureau of Economic Analysis.

While the challenge to innovate confronts all corners of the rural economy, farming regions may face the biggest challenge. U.S. agriculture is far from homogeneous in terms of output, but bulk commodities still account for a big share of both output and exports. With any commodity, globalization creates inexorable pressures to cut costs, making consolidation a powerful force, even during good times. Thus, even though farm income was at all-time highs in 2004 and 2005, farm-dependent counties barely added any new jobs (averaging job gains of just 0.1 percent annually compared with 1.1 percent growth for the rest of rural America).[4]

Rural America's Development Challenge

As the economic trends of the past decade show, globalization has transformed the rural development landscape. The swift currents of global markets mean that rural areas can no longer rely on old economic engines to fuel future growth. When commodities are the game, and the competitors are many and strong, consolidation will leave many rural communities searching for new engines.

Economists generally believe that globalization has ushered in a new era for economic development.[5] The central challenge facing rural regions is the same for all regions in America, indeed in the entire world: *the vigorous pursuit of a competitive edge in rapidly changing global markets*. Building and maintaining that edge will involve three steps: to understand the region's distinct economic assets, to identify the best market opportunities for the region, and to craft a strategy that exploits one to seize the other. This approach yields a unique development strategy for each region. In other words, the new era amounts to the end of the "one-size-fits-all" development policy.

Two ingredients are critical for carrying out this strategy. The first is the twin force of innovation and entrepreneurs. Innovation is the new fuel in creating regional competitiveness.[6] In a global market, where the cost of producing basic products is often several times lower in other corners of the world, the key is to find the next *new* product, not compete on the *old* one. Innovation is the fuel to creating the new products.

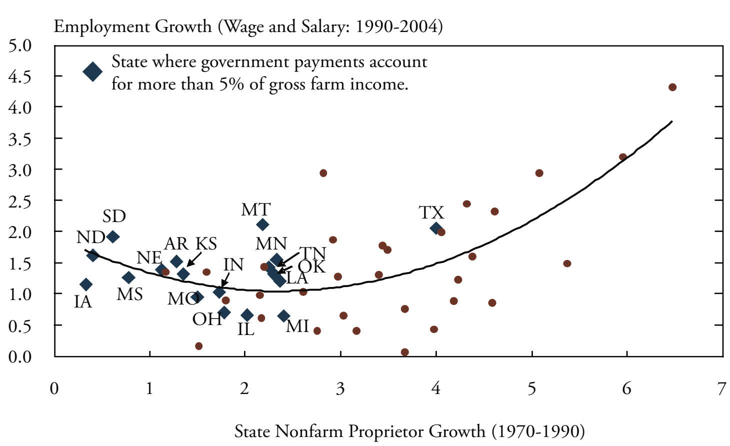
Entrepreneurs bring the new products to market. As old products reach a mature phase and competition for them intensifies, regions need more than the fuel of new technologies and fresh ideas. They also need entrepreneurial engines to take new ideas to the marketplace. Not all of these engines will keep on running, but those that do will define a region's competitive edge in the marketplace.

While innovation is difficult to measure, entrepreneurs are easier to track. Since business starts also reflect the current stock of ideas moving to market, measures of entrepreneurial activity essentially provide a useful proxy for both ingredients.

Recent research points to a strong link between entrepreneurial activity and economic growth. For some time now, economists have shown that nations that grow more entrepreneurs tend to experience faster economic growth rates.[7] The same link has been explored across the 50 states, with the same result (Chart 2). What is more, the economic impact appears to go up as entrepreneurial activity increases. In other words, there is a clear bonus to places that are good at fostering entrepreneurs.

Such evidence underscores the importance of regions that innovate and have entrepreneurs that move those new ideas to market. The dilemma for many rural regions is that they appear to be lagging well behind in this process. As further shown in Chart 2, states where agricultural subsidies are especially important to farm income are all clustered on the left side of the chart. That is, they have low levels of entrepreneurial activity, and economic growth is correspondingly low. The one exception is Texas, which falls toward the other end of the spectrum. An argument can be made that Texas is actually many states—with the agricultural panhandle a very different place than the high-tech mecca of Austin.

Chart 2
State Entrepreneurial and Employment Growth



Calculations based on Regional Economic Information System data, Bureau of Economic Analysis

The second key ingredient is critical mass. A growing body of research shows that the fastest growing regions have sufficient human, financial, and social capital that important synergies develop. These synergies involve a whole host of things, including technology transfer, workforce skills, entrepreneurial networks, and the mere lifestyle amenities that knowledge workers increasingly expect. Economists lump all these synergies into a concept they call "agglomeration."

Research increasingly shows that locations with more agglomeration appear to be growing faster in the 21st century economy. The earlier data on the fastest growing 310 counties is one piece of evidence, but there are many others. Economic innovations (as measured by patents) occur at a faster rate in metro areas, and faster still in the biggest metro areas.[8] While entrepreneurial activity is spread across the U.S. landscape, entrepreneurs that add greater economic value tend to cluster in metropolitan areas.[9] Economists continue to explore the reasons behind these findings, but in general they conclude that places with a lot of agglomeration, like metro areas, can lower the cost of finding and obtaining specialized labor and inputs and provide a more fertile climate for knowledge to be shared across entrepreneurs, workers, and financiers. Such places also have a large supply of leaders that can help create a vision to guide the region's public and private investments.

Be that as it may, agglomeration poses a real dilemma for rural areas. By definition, rural areas are small and remote. Agglomeration is an abstract notion, not a natural feature.

Does that mean rural areas are doomed in the new economy? No, there are ways around this dilemma. Experts now believe that rural communities can create many of the benefits of agglomeration by partnering across city limits and county lines laid down generations ago for a very different economy. The overall purpose of such partnering is to create a development climate where ideas flourish and entrepreneurs grow. While economists may never be able to determine how much critical mass is enough, suffice it to say that most rural communities cannot get there alone.

In sum, the new paradigm for economic development is powerful, but it also challenges rural regions. The shift to an innovative, entrepreneurial economy will not be easy in rural America. Most rural areas have put their development eggs squarely in the basket of business recruiting, putting little if any focus on growing entrepreneurs in their own backyard.[10] To gain critical mass, rural communities will have to partner across jurisdictional lines. Yet rural communities are not accustomed to reaching across those lines—Friday night football dies hard in rural America. Finally, crafting a competitiveness strategy—a region's road map to its economic future—requires leadership capacity. Such capacity is not spread evenly across the countryside, posing yet another challenge to rural areas.

The role for policy in rural development

Given the development challenges in rural America, what can federal policy contribute? Let me suggest three policy directions:

- *Help rural regions craft new competitiveness strategies.*
- *Link ongoing federal investments in research to these strategies.*
- *Build a more effective support system for rural entrepreneurs.*

Together, the three may extend beyond the purview of this committee, but programs within this committee's jurisdiction could make some significant contributions.

Craft new competitiveness strategies

Job one for every rural region will be to craft an effective competitiveness strategy. This strategy will reflect the region's own best assessment of the economic niche where it stands the best chance of ongoing success. Public officials and private leaders alike will have important voices in crafting this strategy. Can public policy help?

In many respects, this question frames the future of the Extension Service. Historically, the Extension Service was the federal answer to calls to help rural America create a more competitive economy. Then, it was about transferring technology and helping farms and farm households become more efficient. Today, rural America's competitive edge no longer lies only in agriculture, but in a wide range of economic niches. Even within agriculture, some regions will continue to focus on commodities, while others will narrow their strategy to specific products.

What might federal "extension" mean in a 21st century quest for a competitive rural economy? Three areas are worth exploring.

Leadership capacity is perhaps *the* essential ingredient as rural regions forge new competitiveness strategies. Several skills will be critical to success: creating a sustainable forum for regional dialogue, diagnosing new sources of competitive advantage, and building a consensus vision for the region.

These "competitiveness" skills will need to be honed. Is there a federal role in the honing? At least some other countries around the world have answered that question in the affirmative. Italy, for instance, dedicates 15 percent of federal regional development funds to train regional officials in "competitiveness skills."[11] Is there a corresponding federal role in the United States?

Apart from the skills to make sound decisions, many rural regions need better economic information in preparing for the task ahead. For more than a century, the USDA has been the definitive source of information on the farm sector and the rural economy. That information was organized around the central premise that a strong farm economy means a strong rural economy. But that premise no longer holds in most parts of rural America. Today, rural leaders need to understand their competitive position, what their key economic assets are, and where markets critical to their region are headed. Is there a federal role in creating a new economic dashboard for rural America?

Finally, new tools might be created to help regions build effective strategies. Every region will need to build an effective means of making decisions, what many analysts now refer to as "regional governance." Currently, there are very few practical guides to doing this. Similarly, regions will need analytical tools to identify promising new sources of competitive advantage, tools that lay a region's assets alongside available markets and then winnow the field of potential economic niches to those that seem to hold the greatest promise. Such tools simply do not exist today. Is there a public role in helping to create them?

Answers to all these questions have not been reached, nor are they likely to come quickly. Yet a case could be made that they all fall within the bounds of a federal goal of helping rural America compete in the 21st century global economy.

Link federal research investments to rural strategies

For more than a century, the federal government has invested in basic research aimed at making the rural economy more competitive. But this investment focused mostly on a single sector—agriculture. The Hatch Act, for example, created agricultural experiment stations in every state. The USDA has an Agricultural Research Service, while USDA's Cooperative State Research, Education, and Extension Service extends the research network to land grant universities, focusing on colleges of agriculture.

To be sure, agriculture will remain an important anchor of the rural economy, but rural America's need for innovation has become much, much broader than agriculture alone. Tourism, advanced manufacturing, producer services, and even new highly specialized niches of agriculture itself represent the future for many rural regions.

Obviously, the federal government invests in a lot of basic research other than agriculture, including medicine and transportation. Allocating federal funds across this research spectrum is a complex task.

From rural America's perspective, however, one issue will be particularly important. New mechanisms are needed to link emerging research knowledge with the economic strategies of individual rural regions. This link is crucial because innovation has become the hallmark of competitive regions, and research is a powerful driver of innovation. Historically, the federal research effort aimed at rural America was tied to individual sectors, and agriculture in particular. Going forward, it will be critical to create stronger links between the research pipeline at public universities and the competitiveness strategies of individual regions (Figure 1). A focus on individual sectors may be an effective way to organize researchers, but an additional question needs to be asked if the federal government wants to ensure that new knowledge *also* advances the goal of making regions more competitive:

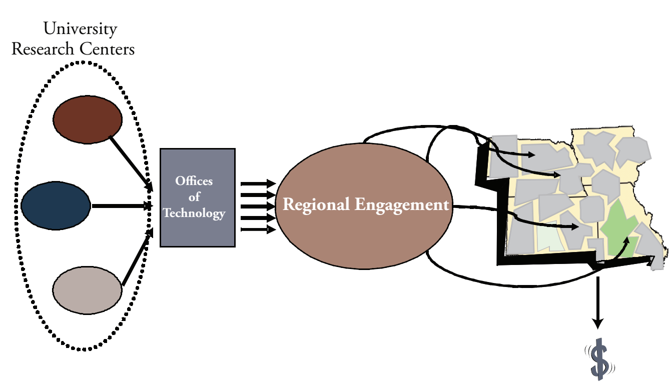
Which federal research breakthroughs will particularly advantage which rural region?

The link between research and regions does not exist today because most rural regions do not yet have clear strategies and because federal research is focused on sectors, not regions. Thus, federal policy may want to create an explicit mechanism to link federal research with regional competitive strategies, as suggested in Figure 1. The purpose of this mechanism is not to interfere with the research, but rather to create a sort of clearing house that connects new research with regions that might make best use of it. This "brokerage house for research" would mark frontier work, since such a mechanism simply does not exist today in the United States or elsewhere. Nonetheless, experts on regional competitiveness believe there may be a huge economic payoff from exploring this new mechanism.[12]

Build a more effective support system for rural entrepreneurs

Rural America has a strong entrepreneurial spirit, but the evidence suggests that rural start-ups struggle to become high-growth businesses. All entrepreneurs, including the owner of the Chatterbox Café, add value to the rural economy. But high-growth businesses create the biggest economic impact.

Figure 1
A Model for Universities to Engage Regional Competitiveness



One explanation for the paucity of rural high-growth businesses is that the support system for entrepreneurs is much more limited in rural areas. Some researchers compare entrepreneurs to minor-league baseball players—an incomplete bundle of skills that often needs coaching to round it out.[13] These skills include marketing, accounting, legal, and management. A plethora of new initiatives to help enhance these entrepreneurial skills are being tried in rural regions throughout the nation. The Entrepreneurial League System is now in development in North Carolina, Louisiana, and portions of Kentucky, Ohio, and Western Virginia.[14] Home Town Competitiveness aims to grow entrepreneurs on the Main Streets of Nebraska and other states.[15]

These and other trials hold promise, but they beg a bigger question: How can we build comprehensive entrepreneurship programs that are regional in scope and systematic in approach? Many partners will likely be involved in building such programs, including philanthropies, universities, community colleges, and state and local government. But who will provide the backbone for the system, and is that a role for a federal policy?

Equally important, though different in character, will be paying new attention to equity capital markets in rural America. Federal rural development policy has always paid close attention to capital availability in rural America. However, the focus has been on credit, as the name of this subcommittee makes clear. Yet in nearly all corners of rural America, credit is readily available to creditworthy borrowers, whether on the farm or on Main Street.

The same cannot be said about equity capital. Equity capital funds are concentrated in metro areas.[16] In part, this reflects the significant transaction costs in equity participations, which can be offset in metro areas that offer proximity and a high volume of start-up firms. Rural areas offer fewer deals in more remote locations and thus have had far fewer equity funds.

As rural America enters the era of the entrepreneurial economy, its sparse network of equity funds becomes a bigger problem. There are many potential responses. Philanthropies are playing an important role. The Nebraska Community Foundation, for instance, is mounting a new campaign to put charitable donations into equity funds that can fuel new businesses in greater Nebraska. Community development venture funds, such as Kentucky Highlands and Northeast Ventures, have been notable additions to the equity capital landscape. By design, these funds measure performance, not only by the financial returns they generate, but also by the economic returns they bring to their region—a so-called double bottom line.

Notwithstanding such innovations, federal policy has undertaken several initiatives in the past to close gaps in rural equity capital markets. Unfortunately, none has been very successful from a rural perspective. The New Markets Tax Credits were designed to induce new equity investments in distressed areas—rural and urban alike—by offering direct tax incentives to investors (39 percent over 7 years). Relatively few of the credits have landed in rural America; in the FY ’05 allocation, only 16 percent were aimed at rural areas.[17] Small Business Investment Companies (SBICs) were created a long time ago to give commercial banks a vehicle for making equity placements in local businesses. These have not proven popular in rural America; only one SBIC is owned by a rural bank.[18] Rural Business Investment Companies (RBICs) were another attempt to provide federal incentives for the creation of rural equity funds. While sound in concept, very few have become operational.

In short, while there are many interesting public and private innovations to address the rural equity problem, this is a topic that deserves close attention going forward. The irony is that many parts of rural America have considerable wealth, often in the form of farmland. That wealth can be a critical ingredient to fuel a new generation of innovation and business that can build new sources of competitive advantage. But financial mechanisms will be needed to do that. Publicly managed funds are not the solution to the problem—research confirms that.[19] But public policy could play an important role in helping a robust network of funds emerge.

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Edited by Bob Reagan

Endnotes

[1] For statistical purposes, rural is defined as nonmetropolitan areas or counties.

[2] Calculations are based on Bureau of Labor Statistics, Mass Layoff Statistics (MLS) data.

[3] Economic Research Service (ERS), U.S. Department of Agriculture, Farm Income Briefing Room, *www.ers.usda.gov/Briefing/FarmIncome/*.

[4] In 2004, ERS at the U.S. Department of Agriculture defined farm-dependent counties as counties with either 15 percent or more of average annual labor and proprietors' earnings derived from farming during 1998-2000 or 15 percent or more of employed residents worked in farm occupations in 2000. Data are available at *www.ers.usda.gov/Briefing/Rurality/Typology/*. Calculations based on Bureau of Labor Statistics, Local Area Unemployment Statistics (LAUS) data.

[5] The economic literature on this topic is summarized in; Drabenstott, Mark. *A Review of the Federal Role in Regional Economic Development.* Center for the Study of Rural America, Federal Reserve Bank of Kansas City, 2005.

[6] Council on Competitiveness. 2004. Innovate America. National Innovation Initiative Report: Thriving in a World of Challenge and Change. Available at *http://innovateamerica.org/webscr/report.asp*.

[7] *The Global Entrepreneurship Monitor*, available at *www.gemconsortium.org*, provides annual summaries of the relationship between entrepreneurship and national economic growth.

[8] Orlando, Michael J. and Michael Verba. "Do Only Big Cities Innovate? Technological Maturity and the Location of Innovation," *Economic Review*, Federal Reserve Bank of Kansas City, Second Quarter 2005, pp. 31-57. Available at *www.kansascityfed.org/PUBLICAT/ECONREV/PDF/2q05orla.pdf* (Obtained March 24, 2006).

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[12] For a discussion of linking public research and economic development see Martin C. Jischke, "Adapting Justin Morrill's Vision to a New Century: The Imperative of Change for Land-Grant Universities," speech, annual meeting for the National Association of State Universities and Land-Grant Colleges, San Diego, November 14.

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[14] Lyons, Thomas, 2002. *The Entrepreneurial League System: Transforming Your Community's Economy Through Enterprise Development*, Appalachian Regional Commission.

[15] For more information on the Home Town Competitiveness program, see the Rural Entrepreneurship Center at *www.ruraleship.org*.

[16] Brophy, David. "Developing Rural Equity Capital Markets," Financing Rural America conference proceedings, pp.159-172. Federal Reserve Bank of Kansas City, 1997. *Equity for Rural America: From Wall Street to Main Street.* 1998 conference proceedings. Federal Reserve Bank of Kansas City.

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[18] Rural Policy Research Institute (RUPRI). *Rural Equity Capital Initiative: Fund for Rural America Study of Nontraditional Venture Capital Institutions, Final Report*. Available at *www.rupri.org/publications/archive/reports/P2001-11/index.html* (Retrieved March 24, 2006).

[19] Barkley, David L. "Policy Options for Equity Financing for Rural Entrepreneurs", *Main Streets of Tomorrow: Growing and Financing Rural Entrepreneurs*. Conference proceedings 2003. Center for the Study of Rural America, Federal Reserve Bank of Kansas City, pp. 107-127