



THE CENTER FOR  
APPLIED ECONOMICS

# THE FACTORS THAT LEAD TO RURAL ECONOMIC DEVELOPMENT

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From the attention paid by politicians and the press to the role of government in fostering job and wage growth, one would think that economic growth was caused by government action. All fifty states have publicly sponsored economic development efforts designed to attract new firms to their state. Politicians promise to deliver more “good” jobs while denigrating the economic policies of the opposition as fostering the loss of jobs or the growth of “bad” jobs. Many groups from the political left to the right issue rankings of states on business climate, quality of life, litigiousness, access to venture capital and other criteria, many accompanied by explicit or implicit suggestions regarding needed change in government policy.

Often overlooked is that there is little solid evidence regarding which policies are actually successful in fostering growth. This is particularly true for rural areas. However, there is one point that must be stressed at the outset: government is only a minor player in its influence on regional economic growth.<sup>1</sup> The sources of jobs, good or bad, is still the ability of firms to produce products and sell them profitably, and that still depends primarily on geography (location, production resources, market size, and transportation costs).<sup>2</sup> Regardless of government policy, economic growth will not occur if firms cannot produce something that can be sold at a price higher than the cost of production. Nor can a worker be paid more than the value of the product that the worker produces.

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<sup>1</sup>This is as opposed to national growth where government decisions regarding trade policy, monetary and fiscal policy, and regulation have a larger effect. For the most part, these policies affect regional economies in a symmetric fashion. State and local policies cannot influence monetary policy or trade and have a smaller range of possible actions regarding regulation, taxation and expenditure policies.

<sup>2</sup>See Bartik, Boehm and Schlottmann (2003).

This paper reviews the existing findings regarding the factors that influence economic growth in rural areas such as the Midwest. For many years, the presumption was that rural growth and agriculture were synonymous, and that policies that benefited farms would also benefit main street firms. As a consequence, little research effort was expended on factors that affected growth of the rural non-farm sector.

## **Farm Income and Rural Economic Growth**

Over time, as the farm population has diminished and as off-farm jobs have become increasingly important for farm and nonfarm households alike, greater attention has been paid to the sources of growth of the nonfarm sector.<sup>3</sup> One of the consistent findings has been that income support payments to farmers do not spill-over to the nonfarm sector. Counties that have a higher share of income from farm sources grow more slowly. Furthermore, higher farm incomes are associated with slower nonfarm population and income growth. Counties with a higher share of farm income derived from farm subsidies also grow more slowly. It may be that at one time, improvement in farm income was crucial for rural growth, but that no longer appears to be the case in the Midwest.

## **Proximity to an Urban Market**

Other than metropolitan areas with populations of 1 million or more, the fastest growing counties in the U.S. are rural counties adjacent to metropolitan areas. The most consistent source of growth for a rural county has been the ability to access the higher wages and employment growth of a metropolitan area while offering its residents the smaller schools, lower housing costs and quieter existence of a small town. Many critics bemoan commuting as a waste of time and petroleum and trumpet

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<sup>3</sup>See Goetz and Debertin (1996), Monchuk and Miranowski (2004), and Huang et al(2002)

the ugliness and inefficiency of sprawl. Nevertheless, Americans have been moving to suburban areas for 50 years and the opportunity to commute is the surest way for a rural area to achieve population and income growth.

Studies have shown that if transportation between suburban and urban areas improves, the suburbs grow faster. For Kansas, this means ensuring good highway links between rural and urban communities. Urban planners often suggest light rail or other mass transit linkages between suburbs and cities. Light rail costs are excessive relative to usage in states with low populations such as Kansas. However, commuter bus service from more remote towns may make the commute less onerous, increasing incentives for families to stay in or move to more distant small towns.<sup>4</sup>

The biggest attraction for families to live in small towns surrounding a metropolitan area is the lower land prices and housing costs in the smaller communities. Some communities have tried to encourage immigration by offering vacant housing or land at reduced rates, a return to the homestead land offers that originally encourage settlement of the Plains states in the 1800s. Those programs would not be necessary if the community is sufficiently close to a metropolitan area to allow commuting.<sup>5</sup>

## **Economic Diversity versus Clusters**

A common buzzword in economic development circles is clustering. Because cities grow faster than small towns, many have pointed to population density itself as a cause of growth. The rationale is that proximity improves the flow of information, technology and goods and services across firms. Some researchers have taken this a step farther to say that placing similar firms

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<sup>4</sup>See So et. al. (2001) and Kahn and Orazem (2001) for examples.

<sup>5</sup>Census data suggests that commuting decreases with the length of the commute, with the maximum commute being about 1 hour each way.

in close proximity makes all of them grow faster for similar reasons. Evidence supporting that hypothesis is mixed for urban areas. For rural areas, the evidence suggests that clustering is counter productive. Rural counties with more diverse economies, meaning that employment is spread over a broad rather than a narrow range of industries, grow faster than do counties with employment concentrated in relatively few sectors.

The explanation is straightforward. Suppose a given sector of the economy weakens, and firms in the sector lay off workers. A county with many sectors can offer many other places where the workers on layoff can find employment. A county that has all its employment in the single sector will have no alternatives for the workers on layoff, and so they will have to leave in order to find employment. More densely populated areas may be able to support concentrations of firms in a given sector and still have a sufficiently diversified economy to provide some insurance against unemployment in the face of sectoral business cycles. Rural areas cannot. Therefore, efforts to create clusters in rural areas are likely to prove counterproductive.

That said, it is also dangerous to use tax dollars to foster expansion of economic diversity. Making existing firms pay (through business taxes) for the tax reductions and other subsidies offered new firms can create an uneven playing field in local markets. Moreover, evidence that these subsidies actually result in increased employment growth or new firm start-ups is mixed at best, if not negative.<sup>6</sup>

An additional reason to be cautious about competing for new firms is that much of the tax competition occurs between communities in the same region (Anderson and Wassmer, 2000). To the extent that workers in all communities within a region can benefit from new firm start-ups or expansions in any one community tax

competition among the communities is counter-productive (Khan et. al. 2001). Instead, communities within commuting distance of one another should cooperate in their development efforts.

## Education

The popular perception is that rural counties have been afflicted with brain drain, the out migration of educated population from rural to urban areas. In fact, only a small fraction of counties in the United States have actually experienced a reduction in the share of the population with a college degree. More commonly, brain drain in the United States has involved slower than average growth of the educated population. By that definition, rural counties in the Midwest have suffered atypically from brain drain. (Artz, 2003).

Brain drain is a serious concern. The fastest growing segments of the U.S. economy over the past quarter century have been the education intensive sectors of the economy. As a result, the fastest growing earnings have been in jobs requiring a college degree. That suggests that counties suffering from brain drain will find it difficult to grow and raise wages for their residents, a prediction borne out in the data. The fastest growing rural counties over the past 30 years were those with the highest fraction of college educated workers in 1970.

That puts rural counties in a bit of a bind. Educated workers are the most mobile and so are the most likely to leave a county for the higher wages in metropolitan areas. A county that invests heavily in education may simply export their investment to more densely populated areas. This will not be true of rural areas within commuting distance of a metropolitan area. But even for the areas that are more remotely located, not investing in education is counterproductive. The reason is that educated workers remaining in rural areas also earn more, just not as much as they would earn in the urban market. In fact, one of the most consistent factors explaining employment and income growth in

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<sup>6</sup>See Peters and Fisher (2002) for a review of the success of enterprise zones.

rural counties since 1970 is the proportion of college educated workers in the population (Artz and Orazem, 2004).

## Quality of Life

Recently, there has been increased attention paid to the role of local amenities (weather, parks, trails, geological features) on economic growth. A large number of studies have found that rural populations have become increasingly sensitive to proximity to recreational amenities. Presence of water and topographical features, cool summers with low humidity, warm winters, and a preponderance of sunny days have all been found to be important.<sup>7</sup> The problem is that these amenities cannot be changed by policy—they are the natural features of the locale. As a consequence they are not of much use to a rural county in Kansas.

Some economic development consultants have taken the findings for natural amenities and suggested that counties invest in cultural offerings to make up for the lack of natural attractions. Invariably, these cultural offerings must be paid for by taxes on the local population. Consequently, whether such government sponsored amenities actually will have their desired consequences depends on the relative positive and negative effects of government services and taxes.

A common, albeit not universal, finding in studies of rural economic development is that the positives of government services are counteracted if not outweighed by the negatives of the attached tax increases.<sup>8</sup> As a consequence, raising taxes to fund new government services is a risky and likely counterproductive strategy for a rural community.

## Conclusions

What options appear to be available for small towns hoping to grow. The most promising avenue is to access the labor market in a nearby larger community. To the extent that commuting time can be lowered, the local population can grow as a bedroom community. Population growth by itself will create a demand for local services that will create jobs in their own community.

The fastest growing rural counties have been those that have more educated populations. Again, by attracting commuters, small towns can also attract more educated households. In addition, ensuring that the local population is well-educated will raise average local incomes, even if it risks losing a share of the population to urban migration.

Evidence suggests that fostering clusters in small towns is a mistake. Rural areas grow faster when they have a diversified economic base. Using local tax increases to pay for new amenities is also ill advised, as the losses due to the taxes generally outweigh the gains from the enhanced services. On the other hand, making use of whatever natural amenities are available has been shown to raise population growth.

As a final note, the young are the most mobile and have been shown to be the most sensitive to local amenities and economic opportunities. Efforts to attract young families by making housing more affordable may be an option, but ensuring that there is a ready supply of jobs within a reasonable distance is even more important.

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<sup>7</sup>See Monchuk et. al. (2004) or Artz and Orazem (2004) for examples.

See Artz and Orazem (2004), Brown et. al. (2003),

<sup>8</sup>Huang et al (2002), and Miranowski and Monchuk (2004) for examples.



## Further Reading

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The KU School of Business established the Center for Applied Economics in February of 2004.

The mission of the Center for Applied Economics is to help advance the economic development of the state and region by offering economic analysis and economic education relevant for policy makers, community leaders, and other interested citizens.

The stakeholders in the Center want to increase the amount of credible economic analysis available to decision makers in both the state and region. When policy makers, community leaders, and citizens discuss issues that may have an impact on the economic development potential of the state or region, they can benefit from a wide array of perspectives. The Center focuses on the contributions that markets and economic institutions can make to economic development. Because credibility is, in part, a function of economic literacy, the Center also promotes economics education.