REAGANOMICS AND RURAL DEVELOPMENT

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INTRODUCTION

There are many unsettled questions as one attempts to address the subject of this paper. The obvious ones are "What is Reaganomics?" and "What is rural development?" Back of those are many questions having to do with whether policy as it is now being enacted and implemented is actually Reagonomics, or whether it is the end product of the usual leavening process that takes place as political rhetoric is translated into political action and programs. Similarly, public programs at the local level are an amalgam of actions by local, state, and Federal governments. How does one sort out the effects of one of these when all are going through a transition?

One of the more difficult challenges of the paper, however, is to identify the analytical framework appropriate for understanding the impact of current policies on rural development. Numerous analysts, including myself, (Ruttan, Schuh 1975) have lamented the lack of a theoretical basis for understanding rural and community development. This lack of an accepted analytical framework continues, despite the popularity of rural development as a policy goal both here and abroad and despite the rather sizeable flow of resources that has been channeled to rural and community development programs over this past decade.

The body of my paper is divided into two main parts. In the first section I try to sketch out an analytical framework that gives some basis for analyzing the consequences of current government programs on rural development. In the second section I attempt to evaluate some of the consequences of these programs for rural development. At the end I will have some concluding comments.

AN ANALYTICAL FRAMEWORK

The main corpus of development economics is concerned with national aggregates, and throughout most of the post-World War II period has been heavily grounded in Keynesian economics and standard growth theory. Policy issues focus on the level of savings and investment and the measures needed to get them to appropriate levels. Two-sector growth models, with their emphasis on the labor surplus in agriculture, have been an important element of the analytical framework, as have the more recent two-gap models which focus on both the external accounts and domestic savings as well as investment ratios.

I think it fair to say that development economics per se has been relatively stagnant for at least a decade. At least within the tradition of neoclassical economics there have been very few new perspectives or insights.[1] And the central core of work in this area has settled down to empirical work which attempts to identify the time path of development in country X and to suggest ways in which the development process can be accelerated.

An offshoot of development economics - agricultural development - has been more vital and robust. More than its parent sub-discipline, it has incorporated the insights of the theory of human capital and made them the core of the analytical framework. A concensus has emerged on the importance of producing an agricultural product surplus (Nicholls) as the goal of agricultural development, on the central role of the production and distribution of new production technology and investments in human capital in producing that surplus, and on the importance of institutional arrangements in mobilizing resources for investments in human capital and in keeping the process of technical change focused on an efficient growth path (Hayami, et al.).

Much of agricultural development theory has taken output as the endogenous variable or as the goal of policy-makers. It is not overly difficult to shift the focus to per capita incomes as the goal, however, and the same human capital perspective remains quite pertinent.

It should be noted that development economics as I have sketched it out to this point is the original supply-side economics. The emphasis is on increasing the supply of output, and the translation into per capita incomes and the consequences for the distribution of income are largely submerged. Even if one goes back to Adam Smith and The Wealth of Nations one will find this same perspective. It is somewhat surprising that the neosupplysiders of more recent vintage fail to recognize the strong analytical roots to which they might appeal. I rather suspect the failure to see this connection is due in part to a tendency on the part of more recent supply-siders to be transfixed by Keynesian orthodoxy as the antithesis of their policy objectives.

Rural and community development have not to date capitalized a great deal on what we have learned from agricultural development theory, despite the rather obvious connections (Schuh 1975). Instead, it has drawn on central city theory, on the theory of agglomeration, and on what little theory we have regarding infrastructure. The truth of the matter is that rural and community development policy still had very little theoretical base to serve as a guide. Consequently, policy measures have focused on

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[1] An important exception is the new household economics and the emphasis it gives to the economics of time and the importance of household production of human capital and other final products and services.

strengthening the physical infrastructure of local communities and on improving the amenities commonly associated with progressive towns and cities. Needless to say, most of these measures are ad hoc, and have very little additivity or complementarity. The expectation, of course, has been that a strengthened infrastructure and improvements in amenities will attract new industries and thus start a self-sustaining development process. I believe the record will show that these measures have not been very effective.

In the remainder of this section I want to argue that a more satisfactory analytical framework is readily at hand to serve as a basis both for better understanding the rural development process and as a guide to policy. In conceptualizing rural development I want to put the focus on the nonagricultural sector in the abstract. Whether this sector is concentrated in rural towns and cities or dispersed throughout the country-side strikes me as largely irrelevant, or at best a question of second-order importance. The theory of agglomeration will provide insights as to why various economic activities might tend to agglomerate. However, for present purposes I prefer to leave these issues aside.

The new perspective I want to sketch out draws heavily on what we have learned from the theory of agricultural development. It consists of five main propositions:

1. Private firms and private entrepreneurial abilities have to be the focal point of the development process.

The analogy with agricultural development is direct. The thrust of Professor Schultz's Transforming Traditional Agriculture is how to make production activities more profitable so that economic agents of all kinds take actions which ultimately lead to modernization. In the context of rural development, the thrust should be in the same direction, with firms in the non-agricultural sector the focal point of the development process. This approach constitutes a significant departure from the usual emphasis on the infrastructure and on public amenities.

2. Knowledge is the critical input in the development process.

The production and distribution of new knowledge has been the centerpiece of received agricultural development theory. This body of theory would appear to be of considerable relevance to the modernization and development of firms in the nonfarm sector. There are obvious differences, however, due to differences in the nature of the technology and in the economic forces affecting that technology.

Let's consider first the similarities. These are especially notable if one focuses on small firms or small businesses - the primary elements of main-street America. Concentrating on small businesses or small industry provides a closer analogy to the firms which are the focal point of agricultural development.

An important form of new knowledge is that required for improved management. Firms can benefit from knowledge which helps them in decision-making about their production practices, in financial management, and in marketing and market development. Such knowledge could obviously be important sources of income streams and these income streams are the essence of economic development.

As we turn to technology, the picture becomes somewhat more complex. The process technology that has to do with how goods and services could be produced and delivered more efficiently is similar in principle to that for agricultural firms. Making such technology available would be an important source of income streams. The complexity comes from the fact that there is a great variety of firms in the nonagricultural sector producing a wide variety of goods and services. To date there is not a large literature on these issues. But from a policy perspective the recommendations are very similar to those for agriculture. And institutions very similar to those for agriculture are required.

Another complication in the technology dimension is the relative importance of product technology in the case of the nonagricultural sector. New products are often the key to success among nonagricultural firms. And new products need to be created and produced if development is to be self-sustaining. However, new products can be proprietary. If they are, and if they can be patented, there is only a limited role for the public sector to play in the production and distribution of such knowledge. In this area a great deal more theoretical work is required. There may also be a need for new institutional arrangements to produce technology of this kind.

3. New skills for the labor force are usually in strong demand.

The full sweep of the human capital perspective should be as pertinent to the nonagricultural sector as to the agricultural sector. To focus only on skills of the human agent, skills are needed at all levels: at the University level, to provide and develop professional skills for teaching, research, and extension; formal schooling for cognitive skills at the elementary and secondary levels; and vocational training of various kinds. What we know about investments in these forms of capital should be fully applicable to the nonagricultural sector. The policy prescriptions are to invest in developing these skills pertinent to the nonagricultural sector.

4. Linkages and agglomeration are important for self-sustaining development.

Obtaining self-sustaining development requires more than the diffusion of knowledge and skills among the human resources of the region and the production and distribution of new production technology and the realization of a production surplus. Hirschman's backward and forward linkages become important means of extending the benefits of modernization in one sector to those in other sectors. The complementarities among sectors are one of the factors which bring about agglomerations of industries. The combination of the two are what help development in one sector be extended to other sectors and thereby contribute to a process of self-sustaining development.

Entrepreneurs in the private sector may identify the necessary linkages or the complemen-

tarities. Alternatively, planners can play the same role, or may purposely organize economic activities to have a high potential for the realization of such linkages and complementarities. Those who believe in "directed" development believe that planners can better identify these means to further growth. Those who don't believe in it have their doubts about the ability of those in the public sector to have such foresight and vision.

5. The social infrastructure is more important than the physical infrastructure.

I put the emphasis on social infrastructure rather than on physical infrastructure largely on the grounds that it is the social infrastructure that is so critical to providing the investments in human capital. High technology industries are now the driving force of the U.S. economy. If local communities want to be assured that they capture a piece of that action, it is important that they provide the resources, including highly skilled workers, necessary to attract such industries. But providing human capital is a more general issue, and one that is as important in attracting industries that use unskilled workers as in attracting those that employ skilled workers.

The social infrastructure needed to promote self-sustaining development encompasses a wide range of activities. At one level are the institutional arrangements needed to assure a well-nourished and healthy labor force and population. Good health and nutrition are important dimensions of human capital. At another level are formal schooling and the wide range of vocational training needed to provide the skills for a modern, changing economy. And at still another level is the institutional capability to supply the new technology.

It may be in the latter case that the U.S. needs to give more attention to institutional design. The Land Grant Universities have been an important source of process technology for U.S. agriculture. They have done less well by the nonagricultural sector. And they have not done much on product technology. Much of the technology for the nonagricultural sector comes from the private sector. It is time to ask whether there isn't a greater role for the public sector to play in providing such technology.

IMPLICATIONS OF REAGANOMICS FOR RURAL DEVELOPMENT

President Reagan's economic policies have been widely promoted as supply-side policies. If in fact they are, they should promote rural development, as well as the development of the rest of the economy. If they are not, whether they promote rural development becomes an open question.[1]

Three elements of Reagan's policies have received much attention in the press.[2] The first of these is the greater dependence on monetary policy to wring inflation out of the economy. This policy actually started in the Carter Administration, but the Reagan Administration has stuck with it with a high degree of persistence. An important aspect of this policy has been the unwillingness of the Federal Reserve System to monetize the new debt associated with the deficit in the Federal budget. This has forced interest rates up to a level sufficient to absorb the debt with a combination of domestic and foreign savings. The real interest has consequently been at record high levels. But the rate of inflation has dropped off dramatically.

The second element of the Reagan program was the avowed intent to balance the budget. Riding on the significant crest of his election victory and some uncommon political skills he was able to push through rather sizeable reductions in tax rates and significant cuts in budget expenditures - cuts to below what they would have been. These changes have not resulted in a balanced budget, however. The combination of record high interest rates and expenditure cuts have resulted in a sharp recession. Revenues have fallen far behind expenditures, with the result that the deficit is now projected at record levels.

Finally, the Administration wants to increase military expenditures in real terms while at the same time reducing total expenditures. Given the size of this country's military budget, this means that all of the budget reductions are forced into what is approximately 25 percent of the budget. It is for that reason that the cuts in social and other programs have had to be so deep.

The implications of the Reagan economic programs for rural development is so far a rather mixed bag. Moreover, how it will work out over the longer term is still an open question, in part because the political battle over the program still continues.

It is important to note that there have been some unexpected consequences of Reagan's policies. For example, the combination of very high interest rates and the accelerated deregulation of the petroleum industry have resulted in a very significant rise in the value of the dollar. This rise in the value of the dollar has contributed to a farm depression of unusual dimensions (Schuh, 1982). Low farm incomes have contributed to a depressed rural economy in general, and in rural states like Minnesota have contributed to a very depressed general economy (Maki et al., 1981).

Squeezing inflation out of the economy will over the longer term revitalize capital markets. This in its own right will probably contribute to rural development. But some parallel developments may have the opposite effect. Credit and capital markets have been deregulated - a process motivated in part by the discontinuities created by inflation, but given impulse by the 1980 deregulation legislation - legislation that preceded Reagan. U. S. credit and capital markets were at one time highly segregated. Deregulation

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[1] For a detailed analysis of the extent to which President Reagan's economic policies are consistent with supply-side economics, see Schuh, 1981.

[2] Specific details of the Reagan program are presented in an appendix.

has reduced this segmentation, with the result that local demanders for credit now must compete with central money markets for funds. Central money markets, of course, are increasingly a part of an international capital market. This means that the days of cheap credit are probably behind us, even if the authorities should be able to squeeze inflation out of the economy.

An important part of this Administration's policy for rural areas has been to cut back sharply the lending programs of the FmHA for industrial activities. This will make capital for rural development even more scarce. Similarly, the attempt to cut back on municipal bonds will reduce the options of local communities in financing their local infrastructural and development programs.

President Reagan's fiscal policies have some very positive dimensions to them. It seems clear that bracket creep was both exerting very strong disincentive effects and stimulating a great deal of income hiding, in both cases significantly eroding the tax base. The reduction in marginal tax rates should provide some stimulus to the economy. The indexation which is to take place beginning with the 1985 tax year should stop or reduce the bracket creep.

Once the economy turns around it would also appear that there are ample incentives for the private sector to invest in new machinery and equipment and new plants. Whether these investments will be located in rural areas is an open question, however. The large proposed cuts in programs for big cities should make them a less attractive place for business and industry to locate. Hence, we might see a continuation of the recent trend to decentralization of economic activity. That should be a positive gain for rural development.

Another important aspect of the Reagan program is the 25 percent tax credit for new spending on research and development above and beyond the average annual amount spent on such activities over the three preceding years. This provision can lead to increased expenditures on R and D. It is expected to terminate at the end of calendar year 1985, however.

The large increase in expenditures on armaments is not likely to have much of a positive effect on rural America. There may be some scattered localities that will benefit. But in total they are not likely to be significant.

The increased expenditures on armaments are having other negative effects that are quite serious, however. In the search for a balanced budget in the face of increased expenditures on arms, other programs that could contribute to rural development are being cut back substantially. Some of these cuts have dire consequences for the longer term health of our general economy, as well as for rural development. The major issues here are the significant cuts being made in science and technology budgets and in educational support at all levels.

These cuts could not be more ironic. The United States has passed into a post-industrial economy. By all reckoning our comparative advantage now lies in high-technology industries. To be making such large cuts in our science and technology programs and in our educational and training programs at the very time our comparative advantage is moving towards high technology industries could not be a better case of shooting ourselves in the foot.

It is true that fiscal incentives are being provided for greater private expenditures on R and D. But this is not likely to be a replacement for the basic research which needs public support, especially if the incentives have an expected life of only three years. Moreover, there is nothing on the scene to replace the cuts in Federal support for schooling and training.

Another aspect of current policies is the reduction in support for local physical infrastructure - water systems, sewage systems, and transportation. It seems clear that back-migration to rural areas over the last decade has been facilitated by the availability of resources to strengthen these physical infrastructures. Now that the people are there, there will not be the resources to support this infrastructure. The result will either be an increase in local tax rates or a deterioration in services.[1]

Another important policy of the current administration is not to interfere in labor markets - to let people migrate rather than to retrain them for local employment. Such a policy results in the wastage and inefficient use of capital. It also results in the imposition of sizeable negative externalities on both the supplying and recipient region, especially if the direction of the migration is once again towards large urban centers. And perhaps equally as important, it reduces the incentives for state and local communities to invest in schooling and training.[2] To cut Federal support for educational and training programs at the very time that geographic mobility is being promoted could not be more perverse. The result will be a substantial underinvestment in schooling and training nation-wide - a policy that obivously is not in our best national interest.

Finally, an interesting substate regional development apparatus has evolved over recent years to promote rural and community development. At one time all Federal money was being forced through this apparatus. As resources dry up, this system is beginning to wither away. Whether one feels that this is good or bad depends very much on how effective this sytem is believed to be. The future of these institutions will now depend very much on the ability to develop local support for them. This may be a healthy thing.

CONCLUDING COMMENTS

The U. S. economy is now going through a major transition as it once again conducts one of its massive social and economic experiments. It is too early to make more than preliminary judg-

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[1] It should be noted that Federal support for such services had already started to decline during the Carter Administration.

[2] For more detail on this issue, see Schuh, 1982b.

ments about the consequences of this experiment, for the program is far from being in place. My perception at this stage, however, is that we are tilting once again from rural America to urban America, and that we are also returning to the very wasteful development policies of the past which depended importantly on geographic mobility of labor. If the negative externalities of this pattern of development are as large as I believe them to be, the consequence will be a growth rate that is significantly less than we would otherwise be capable of realizing.

This past year has seen many state and local governments facing serious budget and fiscal problems. We should keep in mind that most of the effect of this Administration's restructuring of the budget is yet to be felt. What we have felt so far is largely a consequence of the recession - a consequence of monetary policies.

Finally, the most serious consequence of current policies is the large cuts in support for science and technology and for educational and training programs. These cuts will eventually have a major impact on our ability to compete in an increasingly internationalized economy. Moreover, the consequences will be long-lasting. We will not rebuild our scientific and technological capability overnight. This has important consequences for both rural development and the development of the general economy.

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APPENDIX

SOME DETAILS OF THE REAGAN PROGRAM

1. Projected Federal expenditures on food stamps and welfare have been reduced significantly.
2. The intent is to reduce the number of people on the Federal payrolls.
3. Individual tax cuts:
   a. All individual income tax rates have been reduced 5 percent October 1, 1981, 10 percent July 1, 1982, and an additional 10 percent for 1983. These cuts will average 10 percent for 1982, 19 percent for 1983, and 23 percent for 1984. Each cut is applied to marginal tax rates, or those rates imposed on the last dollar of income.
   b. Tax rates are indexed by the CPI beginning with the 1985 tax year in order to avoid bracket creep associated with inflation. The goal is to keep the reduction in rates a "permanent" feature of policy.
   c. Reduced the top tax rate on investment or measured income from 70 percent to 50 percent, the existing maximum for earned income
   d. Reduced the maximum rate on capital gains from 28 percent to 20 percent, effective June 10, 1981
4. Business tax cuts:
   a. Replaced the complex existing system for depreciating assets over their "useful" lives with a more simplified approach called the Accelerated Cost Recovery System (ACRS). Accelerated depreciation is a major component of the new program.
   b. Extended from seven to fifteen years the period over which businesses can carry forward unused tax credits and offset them against future tax liability.
   c. Allowed a 25 percent tax credit for new spending on research and development above and beyond the average annual amount spent on such activities over the three preceding years. This provision applies to all expenditures made after June 30, 1981 through December 31, 1985.
5. Savings incentives
   a. Increased the amount an individual can deduct for annual contributions to an Individual Retirement Account.
   b. Increased the amount a self-employed individual could deduct for contributions to his or her own retirement plan.
   c. Allowed taxpayers, beginning in 1985, to exclude 15 percent of up to $3000 of interest income.
   d. Allowed banks, savings and loans, credit unions, and other depository institutions to issue one year savings certificates that would earn interest at 70 percent of the one year Treasury bill rate (currently about 14 percent).
6. Estate and Gift Taxes:
   a. Increased from $175,625 to $600,000 by 1987 the total amount of estate and gift transfers that would be exempt from estate and gift taxes.
   b. Reduced the top estate and gift tax rate from the current 70 percent to 50 percent by 1985.
   c. Repealed existing limits on tax-free estate and gift transfers between spouses.
   d. Increased the annual gift tax exclusion from $3000 to $10,000 per donee, with an unlimited exclusion for tuition and medical expenses.