

A Rural Community Safety Net

Kimberly A. Zeuli and Jerry Skees
University of Kentucky

Public policy makers discuss safety nets often these days. The term means many different things to different people. In agriculture, safety nets often refer to transition payments, crop insurance, and other mechanisms designed to support falling prices, crop failure, and low revenue. For people in poverty, welfare and food and nutrition programs constitute a partial safety net. The concept of a safety net for a community, however, is less clear. To some extent, the safety net programs designed to help farmers and residents in poverty also help the rural communities in which they reside. Yet, no comprehensive safety net program specifically intended to manage the economic risk of a community exists.

Economic base theory tells us the community's economic sector that trades with other areas—the basic or export sector—is essential to survival. This sector obtains important additional income for the community by selling community goods and services to those outside the community. Other sectors simply recycle existing community dollars. Without such “recycling” firms, however, community income would be spent in other locales, depleting the town's resources. A new business addition to either sector can be a significant economic catalyst, providing important new job opportunities and local income enhancement.

Given the critical role businesses play, firm retention, expansion, and attraction are necessary strategies for rural community economic development. Consequently, many rural communities are competing for the retention and attraction of businesses. To win, they stake future tax revenue, infrastructure investments, and other scarce community resources. They may not, however, correctly, if at all, measure the risk of the gamble when calculating the expected payoff. The town may be tying their future to a single firm or a single industry. Often, towns fight the hardest for large manufacturing firms that can employ a substantial share of the community's population. If the firm fails or leaves, the community's primary source of income is gone. A community may also fail to recognize the similarity of its firms. Does the viability of the community firms all depend on the stability of the same industry (e.g., coal) or input (e.g., cost of fuel)? If so, the demise of one firm may signal the demise of all. Communities can be just as vulnerable if the firms are linked by relying on each other's production.

Communities clearly need to make careful, comprehensive evaluations of business investment decisions. Just as an individual investor needs a diversified portfolio of investments, communities should also consider the economic diversity—and thus, income risk—associated with the business in question. However,

No comprehensive safety net program specifically intended to manage the economic risk of a community exists.

many risky decisions have already been made, leaving very vulnerable communities. Other decisions may be made based on politics rather than community welfare. The positive short-term political feedback associated with bringing in a major firm, or retaining one threatening to leave, may be impossible to resist.

We are left to ask then, what can be done to help communities who are deserted by companies that supported their economy? What kind of safety net can be provided? The most common first choice is to look towards the government for a solution. In the current policy environment, however, trimming down rather than extending welfare programs is the norm. The creation of a comprehensive (probably costly) community public safety net program is not likely in the current political climate. Even if it were possible, such a program would likely be unwise. It may cause local communities to take on more risk and be less concerned about creating sustainable economies.

Alternatively, an ingenious market-based solution could be created using innovations in the capital market. Consider indexing the community economic measures to similar measures for the region or the nation. For example, one might use per capita income, poverty or even some aggregate measure of local economic activity that is calculated in a fashion

similar to GDP (gross domestic product). The reason for indexing relative to the regional or national numbers is that no one could insure the downturns in the overall economy. The community index would be designed to gauge the well-being of the community relative to a larger region or to the nation.

Given such indexing, it may be possible to insure the risk of the community versus the region. A base would be established so that the index reflects some average value of the community's position relative to the region or nation. As the index drops below certain thresholds, it would reflect some significant problem in the community relative to the overall economy. If the index is properly constructed using careful underwriting, traders or reinsurers in the capital markets could provide the needed capital to indemnify the community or businesses in the community when there is a problem. Obviously, the community or the businesses would give up some premium in the short-term to obtain this protection.

Such an index does not negate the need for the community to attempt to minimize its economic risk and long-term vulnerability. To the contrary, the better the community is at this effort, the lower the premiums for the insurance against downturns in local economy. Beyond completing more comprehensive evaluations of

business investment decisions that correctly account for risk, communities should consider two other strategies. First, they could help create more cooperative forms of business in their town. Cooperatives have been one of the main forces behind rural economic development since at least the 1930s and the spirit of cooperation is prevalent in rural areas. By virtue of being locally owned and controlled, with benefits distributed back to the community, cooperatives are compelled to relate to communities differently than

other organizational structures. They may also be in an ideal position to use index contracts that protect against severe problems in the local economy since they can serve as risk aggregators.

Second, communities need to incorporate an economic diversity objective into their development plans. They need to have an appropriate number of basic and non-basic firms that will ensure the capture and retention of income in the community. As much as possible, firms need to

represent a cross-section of uncorrelated industries. For example, food processing and other value-added agribusiness firms are currently promoted as vehicles for economic growth in rural communities. The 1996 FAIR Act specifically mentions the use of value-added enterprises as an important rural development tool. However, in rural communities comprised primarily of farm families, this strategy could be devastating with a widespread or consistent fall in commodity prices.

In the end, the existence of economic diversity and local control means a more sustainable development path for rural communities. Sustainability, by definition, greatly reduces the need for a safety net. Until truly sustainable communities are developed, however, new and creative solutions for vulnerable communities need to be found.

Kimberly A. Zeuli is an Assistant Professor and Jerry Skees is H.B. Price Professor at the University of Kentucky in the Department of Agricultural Economics.

Risky Business

continued from page 5

directly into production contracts with buyers. This is seen most often in livestock sectors but is increasingly being used in crop sectors as well. Currently, a more standard model in crop sectors is when farmers enter into cash forward contracts with grain elevators. In both models, the contract establishes either the price at delivery or the method that will be used to determine price at delivery. More complex forward pricing strategies involve the use of exchange-traded futures or options contracts. By forward pricing, farmers protect themselves against the potential for lower prices in the future. Yet, many forward-pricing strategies also imply that farmers are unable to take advantage of higher prices should they occur. Forward-pricing strategies that do allow farmers to take advantage of future price increases (e.g., put options) require an up-front premium payment similar to insurance contracts.

Input choices

Farmers routinely make input decisions based, at least in part, on risk management considerations. For example, farmers invest in irrigation equipment to

protect against yield losses due to insufficient soil moisture. In this sense, the decision to purchase irrigation equipment is not unlike a decision to purchase crop yield insurance. Decisions regarding pesticide purchase and application have risk management implications, as do crop variety choices. One seed variety may promise higher yields than another variety during a normal growing season but may be more susceptible to yield losses caused by disease or temperature extremes. Thus, even input choices have important risk management implications. This has become even more apparent in recent years with the emergence of genetically engineered crops. Among currently available genetically engineered crops are those that offer protection against common diseases or insect pests. Of course, when purchasing seed, farmers pay a premium for the genetically engineered crop technology.

Life, disability, liability, and property and casualty insurance

Farms are business entities. As with any business, farm families make important choices regarding the standard selection of business insurance products. Many farm families carry life and disability insurance on the primary farm operator(s).

Liability insurance is becoming increasingly important, especially for farms that utilize hired labor. Most farms will utilize property and casualty insurance to protect the part of farm-family wealth that is invested in buildings and equipment.

These are just a few examples of common risk management practices utilized by farm families. While the specific practices differ they share this common element: *risk protection always comes at a cost*. The farm families that use these and other risk management practices accept a relatively stable stream of losses—the explicit or implicit cost of the risk management practice—in exchange for the unlikely, but possible, risk of a large and financially devastating loss.

References

[1] Anonymous. Quoted in Rejda, George E. 1995. *Principles of Risk Management and Insurance*. New York: Harper Collins.

For more information on risk management strategies for farm families visit the National Risk Education Library at <http://www.agrisk.umn.edu/>

Barry J. Barnett is an assistant professor and an assistant economist at Mississippi State University in the Department of Agricultural Economics.