NATIONAL CENTER FOR ECONOMIC GARDENING

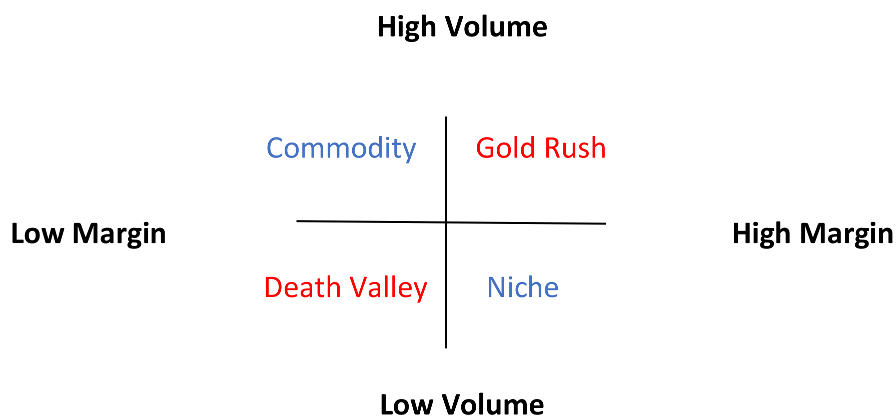
# COMMODITY TRAPS IN RURAL AMERICA

There is a portion of the population in America that is not benefiting from our free market economy. Rural areas in particular are struggling in many parts of the country. They are caught in a system problem called commodity traps which drives down wages and destroys jobs.

What follows is a discussion of the core mechanism that creates commodity traps, how it works in rural economies, and a pathway for getting out of the trap.

## Volume and Margins

Oddly enough, the commodity trap problem starts with this simple little diagram.




What this represents is a basic fact of all businesses: you make money through a combination of margin and volume – how much profit you make on each item times the volume sold. Margin and volume.

These two factors create a 4-quadrant diagram. The vertical axis runs from low volume to high volume and the horizontal axis runs from low margin to high margin. Two of the quadrants are not real in the practical world. A high margin/high volume business (upper right) is like a gold rush. You may find extraordinary riches but the next morning you will wake up with competitors camped all up and down the stream. It's a market condition that does not exist for very long.

The lower left-hand quadrant (low margin/low volume) is Death Valley. It's a situation where we don't make very much on what we sell, but don't worry about it because we're not selling very many of them anyway. Most businesses exist in the remaining 2 quadrants. A low margin/ high volume situation is similar to Walmart. We only make two or three percent on our sales, but we have a very high volume every week. It is a perfectly viable business model used by many mature corporations. The rule for winning in this quadrant is having the lowest price combined with high volume.

The remaining quadrant is a high margin/ low volume option. This would be similar to Apple in which they introduce a new product wanted by the consumer, and for a period of time has no competitors. It allows them to keep high margins until the competitors matched their product. The rule for winning in this quadrant is constant innovation, to keep a competitive lead over competitors.

## Commoditization

Commoditization occurs when competing products no longer have any difference, except for price. Given that the lowest price will win sales in the marketplace, the goal of the company is to reduce expenses in order to reduce prices.

Labor is often a major expense in most companies. To reduce labor expenses, a company can either pay less, outsource it to lower priced countries (say China) or it can replace it with machines and software (new auto plants have very few employees building chassis).

The net result is that in commoditized industries, employees either end up working for lower wages or eventually lose their jobs.

The reason this affects rural communities so often is that they are founded on natural resource industries (farming, fishing, timber, mining, ranching). The economic purpose of the town is two-fold: 1) to gather in the natural resources and send them to processing centers (wheat to Minneapolis, cattle to Chicago, iron ore to Pittsburgh, timber to Seattle, seafood to New Orleans); and 2) to bring necessities into town from other regions (food, furniture, clothing, transportation). Ship out what we make, ship in what we don't make.

Most natural resources, however, are commoditized. Wheat in Kansas is not much different than wheat in Argentina. A 2x4 stud from Oregon looks pretty much like one from Georgia. Alaskan trawlers are pulling the same fish out of the ocean as the Maine trawlers. Iron ore from Minnesota looks like iron ore from Michigan. Wyoming beef tastes like Texas beef.

Commoditization also occurs in generic, job shop manufacturing companies.  A 5-axis CNC milling machine in Iowa can do the same work as one in Ohio.  And one in China.  They are all high-quality machines producing the same top-flight work.  The customer sees no difference in the delivered work, so they take the lowest cost version.  When American companies bid work, they compete with China's workers who are paid 1/3 less. With a high-priced labor force, American companies can't get expenses down, and so they outsource to Asia or go out of business.  In the community, people lose their jobs. Retail stores lose sales. Taxes for public services drop.  Donations to charities dry up.

All of this is a commodity trap.  It is the result of system dynamics, not individual efforts.  You can tell it is a system problem because when you change the people out, you still get the same results.  In commodity traps, there is a constant downward pressure on prices and expenses.  You have to reduce your standard of living to stay in the game.  Good people who work hard, play by the rules, go to church and  contribute to their communities can get caught in commodity traps and end up without a job. *Commoditization is the source of poverty*.

Economic development strategies that focus on bringing in companies from other communities by being the lowest cost place to do business only reinforce commodity traps.  If business costs (labor, materials, real estate, utilities, taxes) start to rise, the recruited company will look for new locations in order to stay competitive.

If a company needs a subsidy to justify relocating, it is a likely sign they are under price pressures and need the taxes of the local community to help keep prices down.  This strategy only digs the hole deeper.  Commoditization is a race to the bottom  -- I can do it cheaper than you; you can do it cheaper than me.  We are on a trajectory approaching zero.

## Bathtub Analogy

A simple way to think about community economic health is a bathtub analogy.  If the bathtub is the community and the water in the tub represents money, then we can think of money circulating around the tub  from store to store.  The office supply owner dines at the restaurant.  The restaurant owner uses the local CPA.  The CPA buys office supplies from the office supply store, who dines in the restaurant again.

In this simple version, a community should be able to go on forever, supplying each other's needs. The problem is that no community in the world makes everything it needs. New York City does not make its own cars or its own carpets or raise its own wheat. Every city, town and village buys some things made in other areas. So, when you buy a car from Detroit or go to Disney World in Orlando, you take some of the money out of the community.

In essence, this amounts to a drain in the tub – a drain in the local economy. The water level drops a little bit every time it happens. The office supply owner may eat one less meal a week at the restaurant. The restaurant owner does her own taxes instead of using the CPA this year. The attorney may not reorder business cards this year. Everyone is just a little bit poorer because someone sent money out of town for cars or carpet or clothing.

On the other end of the tub is the faucet that refills the tub. When you make something and sell it outside of town, it brings some money back in. It refills the tub with water (or the community with money). If the faucet runs at the same rate as the drain, the town has a stable economy. If the faucet runs faster than the drain, the community has more money and starts to grow.

## Innovation

There is a solution to commodity traps, and it is innovation.

If a company innovates something that the customer wants and the competitors don't have, they can sell at higher margins. The customer has no other choices. The higher margins are, in effect, a temporary monopoly that will exist until the competitors can match the offering and start driving prices down – throwing both into a downward spiral into a commodity trap.

As long as the margins are high, there is a lot of money sloshing around in the company. Further, the workforce that helped create the product or service probably has unique skills at this point, giving them supply/demand leverage for wages.

This condition -- where new wealth is created, distributed broadly throughout employees in the company, and then to the community in terms of retail sales, charities, and taxes -- will exist only as long as the company can maintain a lead over competitors. The rule for winning in an innovation quadrant is <u>constant innovation</u>. A strong barrier to entry will also keep that lead in place over a longer period of time.

In short, the economy of rural towns depends on those who sell to external markets (the faucet on the tub). If they sell commoditized natural resources, profit margins will be thin and pressures to reduce expenses will be constant. Over time, they will employ fewer people which reduces money in the town (water in the tub). If they sell innovation, the reverse of all of the above is true.

If the policy solution seems to be that simple – export innovation – why doesn't it occur more often as a strategy in rural economic development? The answer lies in the evolutionary selection process that occurs in commodity traps. Innovation requires "change people" and commoditization favors "stability people."

## Evolutionary Dominance of Stability People

At the very core of an innovative economy is the innovative person. While there are extensive temperament studies that identify preferences for both change and stability, we can arrive at the same conclusion by simply looking at the CEOs of companies that excel at innovation – Steve Jobs, Bill Gates, Elon Musk, Jeff Bezos. Setting at the heart of each of these companies is a temperament oriented toward change. Visualizing and creating a future that is different from the existing is the very lifeblood of these kinds of people. As a shorthand, we can call these "change" people.

The counterbalance to change people are the "stability" people. Stability people have a preference for the known, the tried and true, relying on past experiences as a guide for the future. The stability people consolidate all our learning into rules and procedures that ensure survival (as long as the environment is fairly stable). However, there are times when the environment is changing and the need for company change increases.

So which preference (stability or change) is a good fit in communities that rely on commoditized industries? The razor thin profit margins create an environment that discourages risk. If you stray from the tried and true, and try something new that fails, you probably will not recover. It is like a survival strategy in the desert – the most important thing is don't make a mistake. The options are few and the consequence of error is high.

This "survival of the fittest" pressure in rural towns tends to drive out those who try something new and fail. They leave town with a bankruptcy on their record or go to work for the stability CEOs. The survivors are those who didn't make a mistake, those who figured out the most efficient way to run the business with minimized risk. They became experts at sailing close to the wind. In a commodity environment, evolutionary pressures favor conservative approaches and drives out new approaches. Exploitation wins over exploration.

## Growing Innovative Companies

Charting a course for building innovative companies and communities includes at a minimum, these elements:

- Changing the conversation
- Identifying the innovation temperaments
- Building an entrepreneurial ecosystem
- Investing in community amenities and place making

### Change the Conversation

The first step starts with changing the conversation from recruiting commodity companies to growing local innovation companies. If the conversation is about how to get some other commodity industry to locate in town because of our cheap costs, then we will only strengthen the commodity trap. If the conversation is about local entrepreneurship (which Economic Gardening introduced 35 years ago), and innovation sold outside the community, then we are embedded in the right conversation, facing in the right direction, doing the right thing, and the only remaining problem is scaling.

It is important for a broad portion of the community to understand how and why a local economy works. In particular, rural communities should understand:

- The bathtub analogy
- Niche vs. commodity
- Commoditization (low wages, loss of jobs)
- Commodity traps (the destruction of communities)
- The role of Stage 2 companies that export innovation (the faucet in the bathtub)

### Identify the Innovators

The second step is to find the existing innovators, potential innovators and the students who may become innovators.  Build programs that contribute to their success. (Economic Gardening has focused on this group for 35 years).

### Build an Entrepreneurial Ecosystems

There is a strong movement, centered in the Kauffman Foundation based in Kansas City, called building Entrepreneurial Ecosystems. It is a work in progress but potential elements include:

- Business infrastructure  for innovation companies
    - Specialized finance, legal, engineering professionals
    - CEO round tables and business networks
    - Internet access to labor force, markets, supply chains, industry information
- Intellectual infrastructure
    - College courses / telecourses
    - Workforce training
    - Access to industry information/industry centers

### Invest in Community Amenities / Placemaking

In addition to business infrastructure, we need to remember that entrepreneurs want to live in thriving communities.  The Project for Public Places coined the term "placemaking" to improve public spaces and community amenities. Projects like restored historic downtowns, bicycle and hiking trails, community recreation centers, well designed public forms, diverse housing types,  public art, summer concerts, good zoning and urban planning practices all contribute to attractive places to live and work.. Encouragement of restaurants, night life, music venues, and coffee shops all appeal to younger generations and contribute to enriched hometowns.

## Closing Comments

Commodity traps are the problem and exporting innovation is the answer.  The pathfinding portion of the job is finished; we now know why and how towns grow and die and what it takes to get out of commodity traps.  The job remaining -- going down that path – is the hardest part. The checklist includes changing the conversation, finding and supporting innovation people, providing a business infrastructure for local, scaling companies and investing in community placemaking.

The problem is that almost everything an innovation company needs is scarce in rural communities. It is part of the reason that innovation companies are also scarce. We should be clear eyed that it will be a long, slow slog over generations, but the good news is that it will compound on itself. Change will start out small and incremental and like an ocean liner leaving a dock, the first 100,000 horsepower will move the ship about a foot. The next 100,000 hp will move it a yard and eventually it will sail under full steam at 35 knots.

The most important thing is to get started with the first example. Just do one and establish the model to show a pathway for others to follow. Get one young person innovating online, or one established company to create one new product to sell outside the community at a high margin.

Along with that, the single most important *infrastructure* project is high speed internet. The Internet is the great game changer which has leveled the playing field for many rural communities. Fifty years ago, a town had to have access to natural resources, labor force and markets. Today, it can tap into distant markets, specialized labor, professional support, strategic alliances and industry networks from anywhere in the country that has high speed internet.

A final comment. There are places in the country where the local economies are vibrant and poverty rates are low. If we examine them closely, we will see they live on innovation and have avoided commodity traps. We should take note of that.