

The role of small and large businesses in economic development

One of the models traditionally used by U.S. communities to develop their local economies has been to recruit large businesses into their area by offering them tax breaks and other financial incentives. But in recent years, many communities have abandoned this model and instead have focused their efforts on developing new, smaller businesses and fostering an environment in which existing ones can grow. In a recent study in the Federal Reserve Bank of Kansas City's *Economic Review*, senior bank economist Kelly Edmiston examines the impact of this shift in development strategy by comparing the costs and benefits of the two models.

Edmiston begins his study with a discussion of the traditional model and argues that when large (100 or more employees) firms move into an area, the “net economic impact” on the local community is not always positive. Although these firms create jobs and generate income, their “indirect effects” on other firms tend to offset some of the gains. Existing companies will not expand as they would have or they might go out of business altogether. Other companies that would have moved into the area will locate elsewhere. Edmiston cites one study, for example, in which a new plant opening with 1,000 employees led to a net gain of only 285 jobs over a 5-year period. Other studies cited by the author show that “negative effects dominate with many large-firm locations.”

Edmiston also compares various aspects of job creation in small and large businesses and concludes that while small firms are “potent job creators,” larger firms tend to offer better jobs in terms of compensation and stability. He finds little evidence that the net employment gains from small businesses are any greater than those from large businesses, and most net employment gains come from the expansion of existing firms rather than from newly established ones. The final portion of the study looks at innovation and finds “little convincing evidence” that small firms are any more innovative than large firms.

Boomers and the economy's future

As more baby boomers become eligible for retirement, what effects will this have on the U.S. economy? Kevin Kliesen, an economist at the Federal Reserve Bank of St. Louis, considers this topic in a recent issue of the Bank's quarterly periodical, *The Regional Economist*.

Kliesen uses a standard growth accounting framework to estimate how gross domestic product (GDP) growth can be expected to change as the baby-boom generation—born between 1946 and 1964—heads towards retirement. This framework combines three factors: projected population growth, a projection of labor force participation growth, and projected productivity growth. Adding these up yields an estimate of future real GDP growth.

Population projections cited by

Kliesen show a slowing of the rate of adult population growth from 1.2 percent per year in the 1990–2006 period to 0.9 percent in the 2007–2017 period and 0.8 percent in the 2018–2028 period. The labor force participation rate dropped slightly from 1990 to 2006; projections suggest a more rapid drop in labor force participation between 2007 and 2017, and an even faster decline between 2018 and 2028. He mentions that the labor force participation rate could decline less than projected, but considers this to be unlikely.

For the last piece of the puzzle, productivity growth, Kliesen assumes that the average rate of growth of about 1.8 percent per year in the 1990–2006 period will continue in the two subsequent periods. Putting it all together, Kliesen finds that “the growth accounting framework projects that real GDP growth will slow from an average of 3 percent per year from 1990–2006 to 2.5 percent per year from 2007–2017 and then to 2.2 percent per year from 2018–2028.” He does acknowledge that faster productivity growth could have a mitigating effect, but mentions several reasons why this might not happen. □

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