



FEDERAL RESERVE BANK *of* KANSAS CITY

Firm Size and Economic Development

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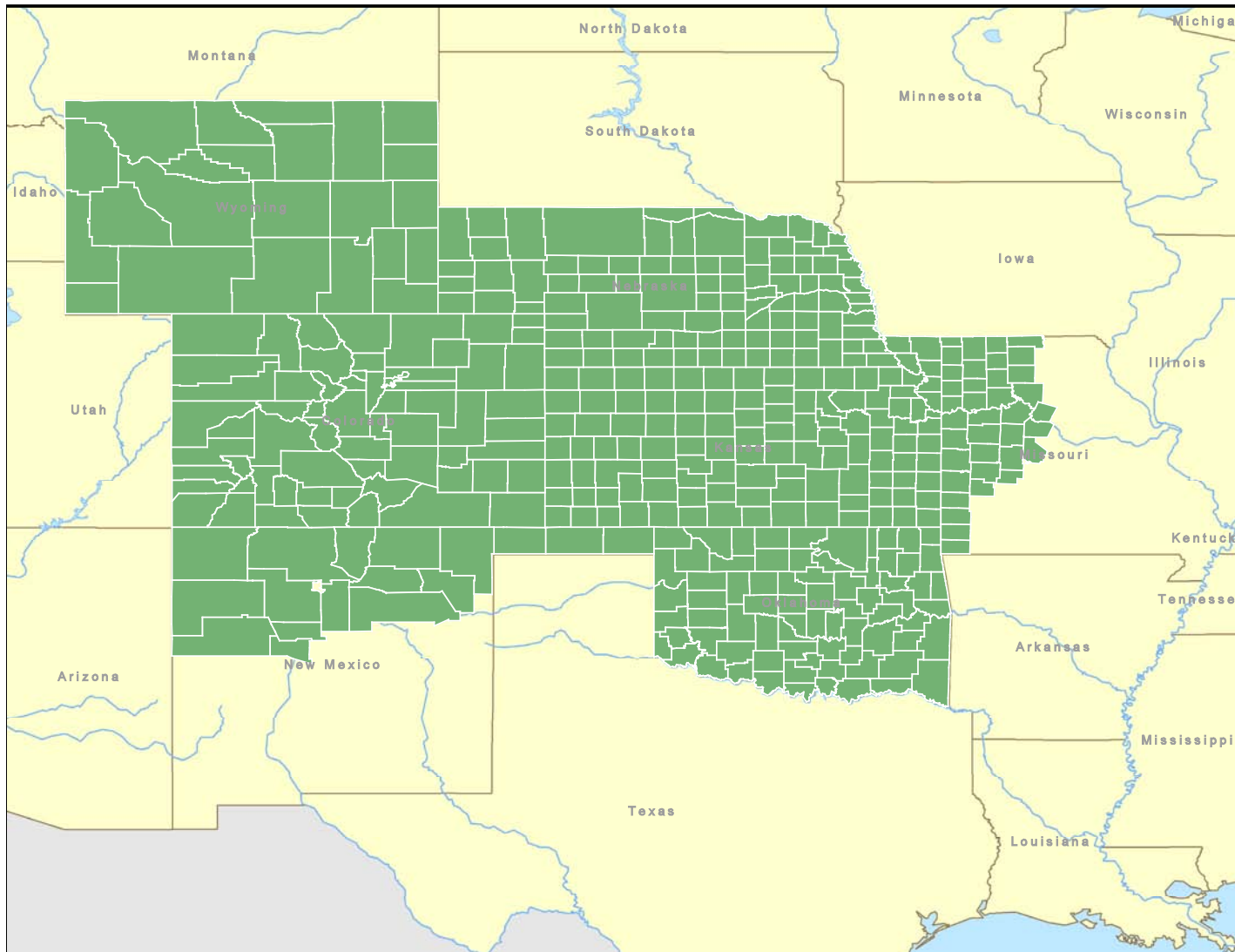
Council Bluffs, IA

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Disclaimer

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Federal Reserve Tenth District



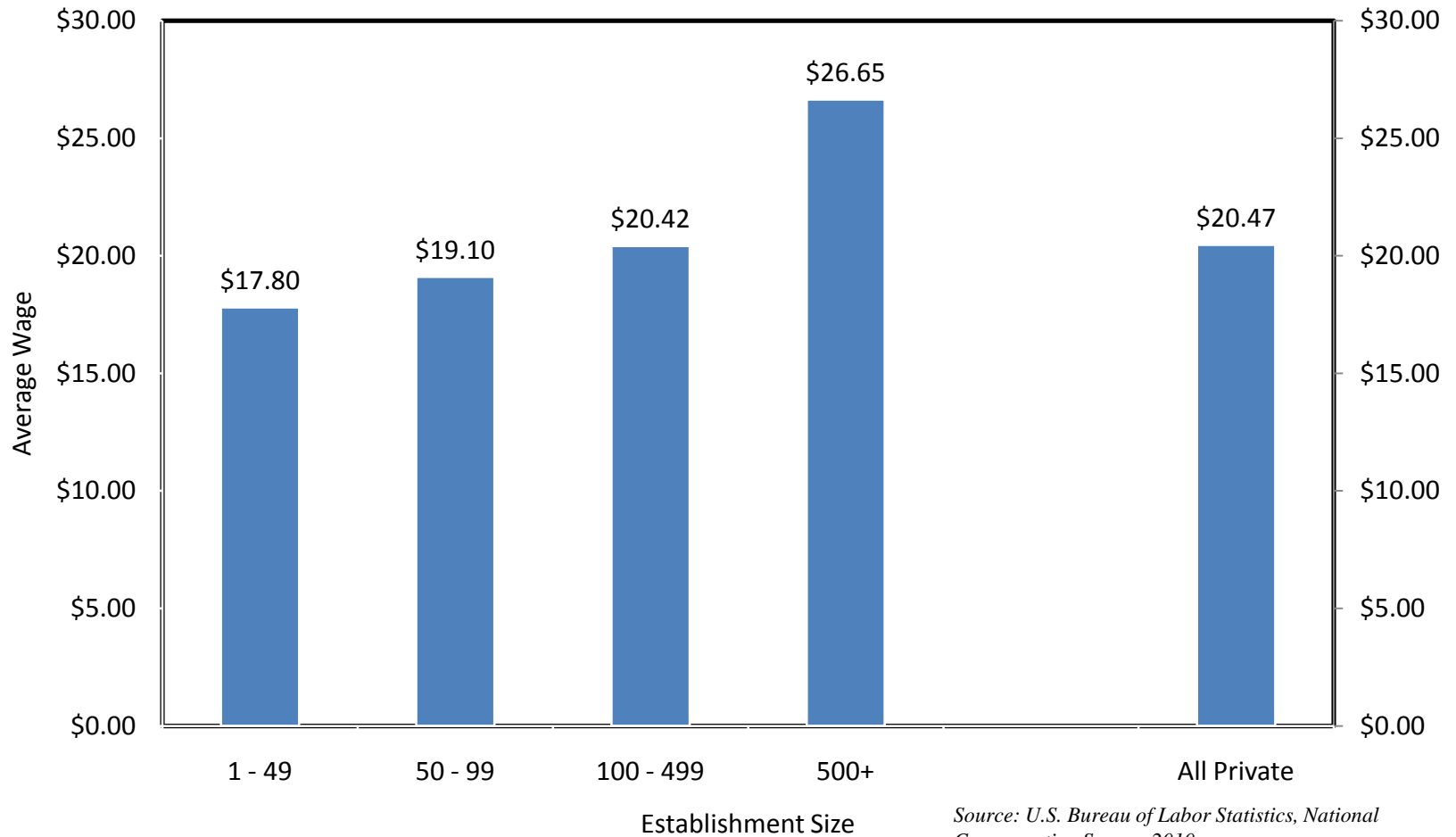
Roles of the Federal Reserve System

- Promote an efficient payment system
- Safeguard the banking system
- Promote economic growth and price stability

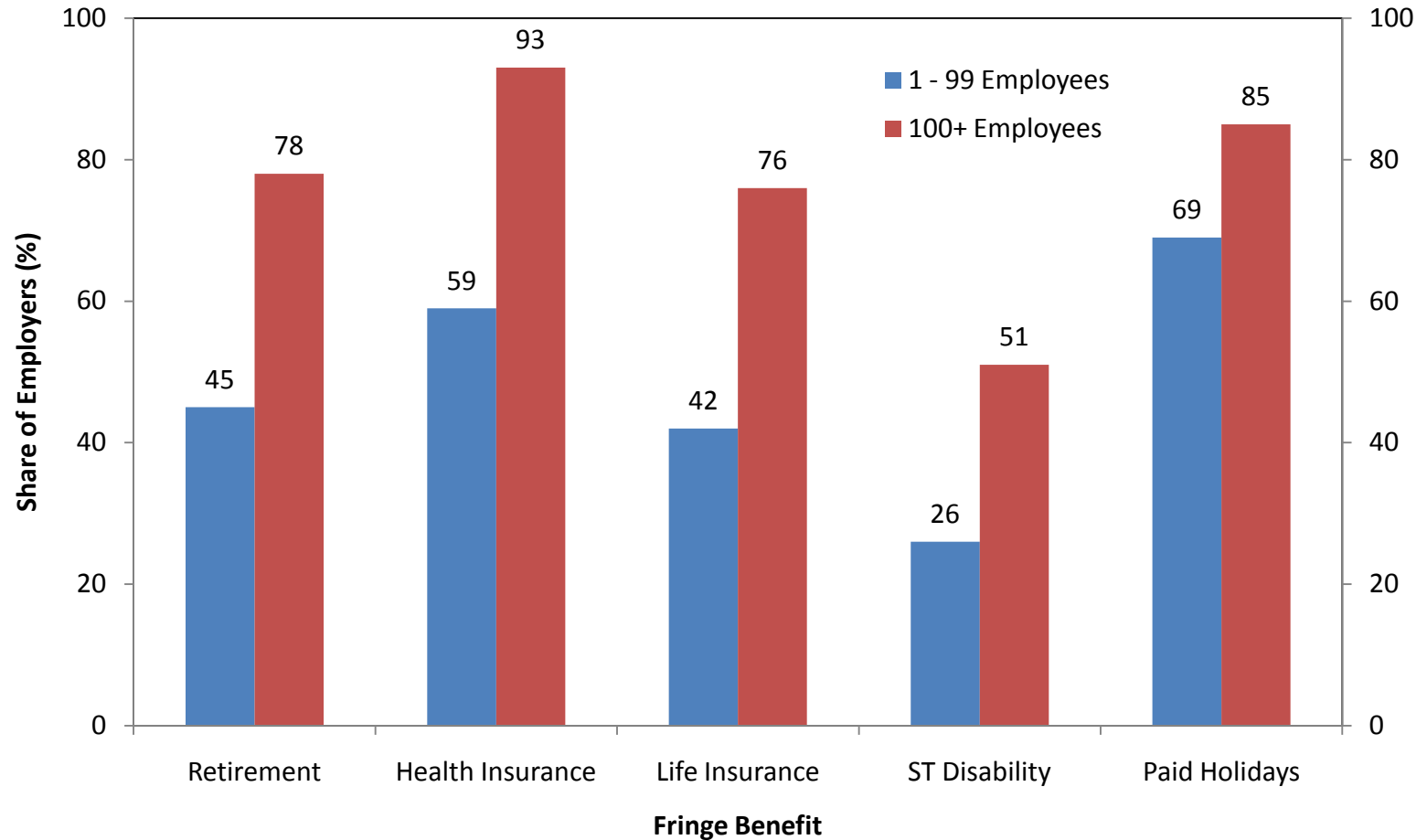
The Role of Small and Large Businesses in Economic Development

- Why Recruit Large Businesses?
- Small Businesses, Job Growth, and Innovation
- Economic Development Policy: Small Businesses vs. Large Businesses
 - Policy Effectiveness
 - Competition

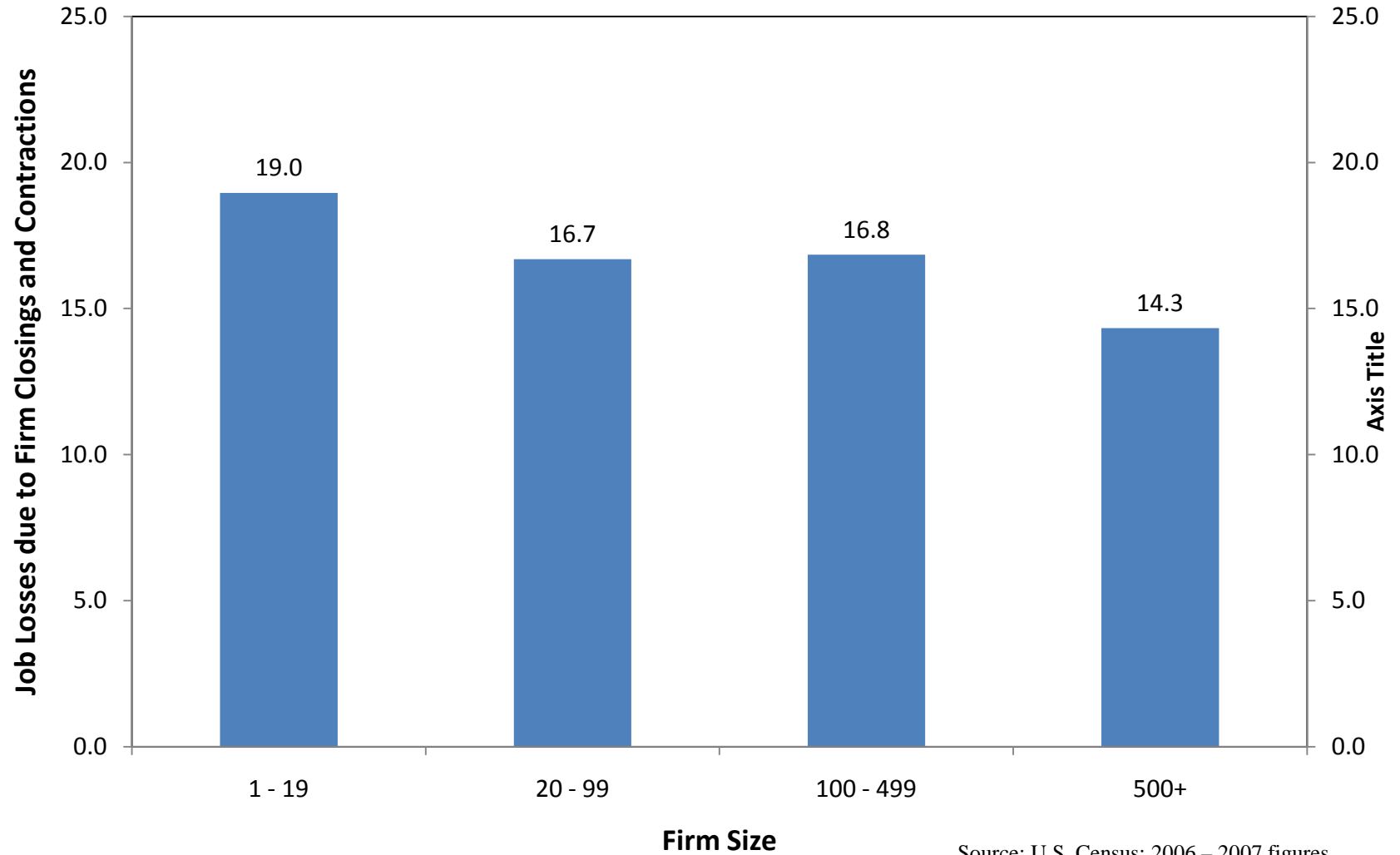
Why Recruit Large Businesses? Pay.



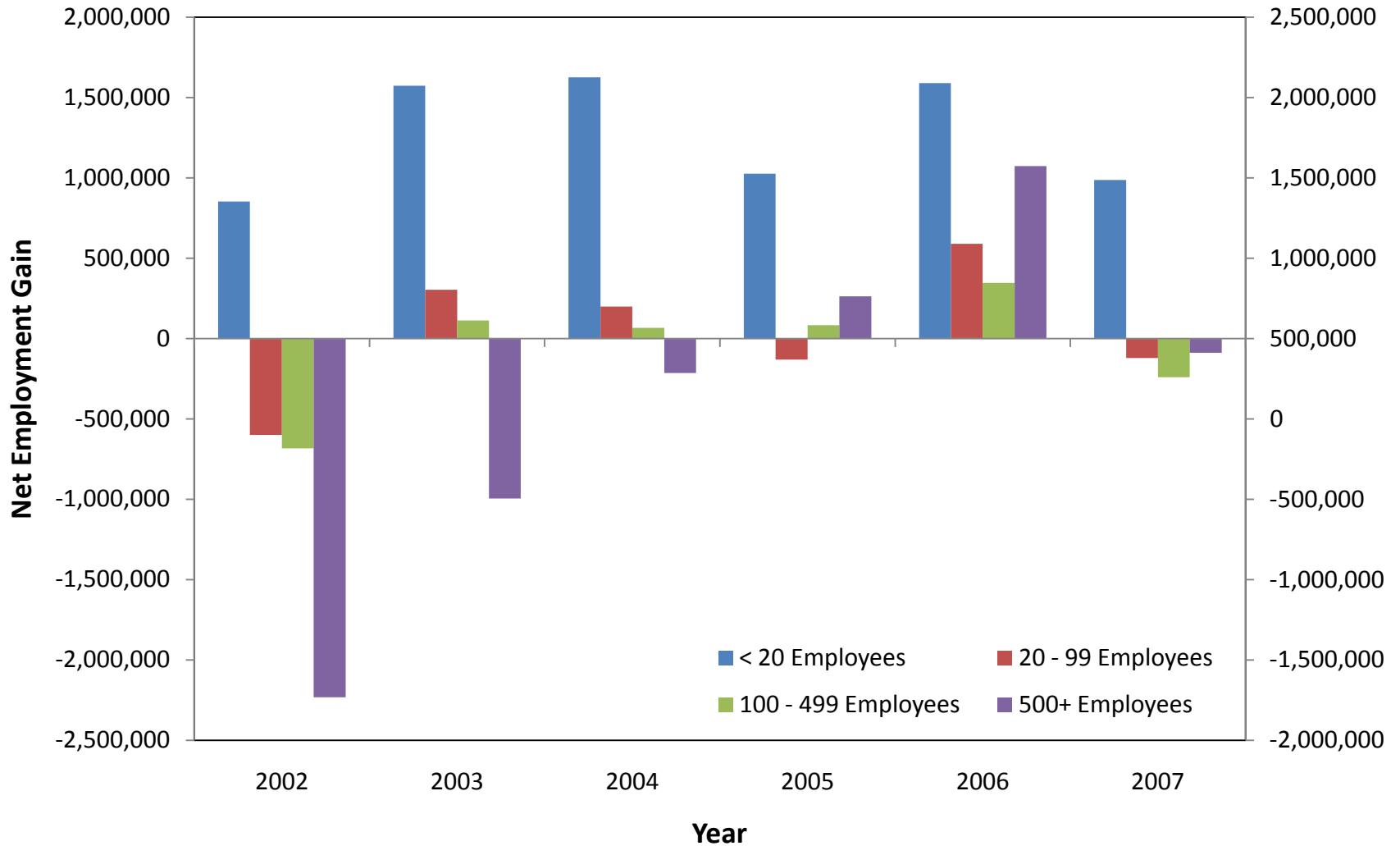
Why Recruit Large Businesses? Benefits.



Why Recruit Large Businesses? Stability.



Businesses Size and Job Creation



Why Might Large Firms Be More Innovative?

- R&D fixed costs can only be recovered with large sales volume
- Better access to external financing for R&D
- Better access to internal financing (with higher profitability)
- Simultaneous projects means diluted risk
- Better name recognition and established marketing channels means greater opportunity to market and sale innovations
- Often compete on quality and product differentiation, meaning greater incentives to innovate

Why Might Small Firms Be More Innovative?

- Lack of entrenched bureaucracy means
 - Shorter chains of command
 - More efficient communication
 - More flexibility
 - Better managerial coordination
- Often more competitive environment, meaning more incentives to innovate
- Ownership and management more likely to be intertwined

What the Research Says

- R&D intensity increases with firm size in some industries and decreases in others
- To the extent a generalization is possible, the result is likely a moderate U-shape

Economic Development Policy

- Large firm locations are unlikely to be successful, and not cost-effective when they are
- Local competition for firms aggravates this situation

Unlikely Success

- Economic inefficiencies: society produces less with the resources it has available
- Budgetary implications
- A focus on a particular firm or industry is risky because sorting prospective winners and losers is difficult at best
- Industrial incentives and other large firm recruitment efforts often do not work or have limited impact

Picking Winners and Losers: United Airlines

- Touted as the “most efficient and one of the largest aircraft repair facilities ever” and opened in 1994 (construction began 1990)
- “Won” by Indianapolis with a \$300 million - \$450 million incentive package
- Announced employment was 7,500 (\$40K - \$60K per job), but actual was more like 1,500 (\$200K - \$300K per job)
- Closed for good in May, 2003

Picking Winners and Losers: United Airlines

- Costs for Indianapolis
 - \$697,000 annual foregone rent
 - \$5.2 million in 2003 and \$6.1 million annually in 2004 and beyond to preserve the facility
- Oklahoma City Mayor: Losing United was the best thing that ever happened to us.

Net Impacts of Firm Locations

- Positive Spillovers
 - input-output linkages
 - agglomeration effects
 - labor pooling
 - knowledge spillovers
 - employment and income multipliers
- Negative Spillovers
 - infrastructure congestion
 - wage and rent pressure
 - reduced supply of resources
 - perception that this might occur

Source: Kelly D. Edmiston, 2004, "The Net Effects of Large Plant Locations and Expansions on County Employment," *Journal of Regional Science*, 44 (2), 289 – 319.

Net Impacts of Firm Locations

- For the *average* large firm location, a thousand new jobs yields only 285 net new jobs.
 - One study suggests that the net is closer to zero
- For the *average* large expansion of an existing firm, a thousand new jobs yields 2,000 net new jobs

Source: Kelly D. Edmiston, 2004, "The Net Effects of Large Plant Locations and Expansions on County Employment," *Journal of Regional Science*, 44 (2), 289 – 319.

Regional Competition for Economic Development

- Some Interjurisdictional Competition is Welfare-Enhancing
- Interjurisdictional Competition for Business and Industry Generally Is Not Welfare-Enhancing
- The Prisoner's Dilemma

The Prisoner's Dilemma and Regional Development Competition

Region B

Incentive No Incentive

	Incentive	No Incentive
Incentive	-1, -1	1, -3
No Incentive	-3, 1	0, 0

Region A

No Incentive

Going Forward

- While large firms offer better jobs on average and contribute significantly to job creation and innovation,
 - most net new jobs are created by small firms
 - large firm recruitment is unlikely to be successful, or successful only at great cost
 - a focus on a particular firm or industry is risky
 - large firm recruitment can breed damaging competition

Going Forward

- Expanding existing industry can be very successful, but still should weigh costs and benefits before incentivizing
- An important strategy going forward is focusing on quality of life issues

Going Forward

- Economy rapidly shifting towards locally-provided services and information-based production
- Biggest issues is recruiting the right workers
- Success requires building
 - Quality of life (for families also)
 - Regulatory and fiscal environment conducive to business

Kelly Edmiston, “Attracting the Power Cohort to the Tenth District,” *Federal Reserve Bank of Kansas City Economic Review*, 94 (4), 69 – 91.

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