

PART 3

What True Leaders MUST Understand about Economics

A discussion with Dr. Bruce Domazlicky, Director of the Center for Economic and Business Research and Professor of Economics, Southeast Missouri State University facilitated by Dennis Roedemeier, CEO of the Missouri Research Corporation

Foreword

In our previous section, we discussed the importance of entrepreneurs to economic development. We also discussed what “free riders” are. And do you recall why corporate profits sometimes are looked down on by consumers? It is easy to forget these important economics basics if you don’t use them often. Part Three of this series builds on information from the first two parts, introducing the multiplier effect and the location quotient. Read on to learn about or review what leaders MUST understand about economics.

This is Section Three of a Four-Part Series...

DR: All of us in economic development preach the doctrine of the “multiplier effect”. Can you explain this effect? And just how important is it?

BD: Local government officials deal with many items that have regional economic implications.

They run across concepts that have a ring of familiarity to them, but are still somewhat alien.

One of the first that an official will typically hear about is the concept of the multiplier. The idea

of the multiplier is not very difficult. Suppose your town is fortunate enough to land a new

business that will hire 100 employees with an annual payroll of \$5 million. Those new

employees (for simplicity, assume that the employees were not drawn away from other

businesses, but represent 100 people newly employed) will have higher incomes (\$5 million in

the aggregate) that they will then spend on local goods and services (food from the local grocery, haircuts from a barber, clothing from a department store, etc.). The owners of the grocery store and department store, and the barber will all have higher incomes as a result of this spending.

That will cause them to increase their spending in the local community, leading to higher incomes for other people in the community, who will increase their spending, and so on.

In addition, the new business may buy supplies from existing local businesses, boosting the incomes of their owners, leading to more spending, etc. Therefore, the initial increase in payroll of \$5 million gets multiplied as incomes and spending increase in the local community. I have seen estimates of as high as 6 or 7 for the subsequent total increase in income and employment due to a new employer in town. The reality is that the multiplier for a medium-sized town is



likely to be around 1.5, and may approach 2 for very large cities. Even for an entire state such as Missouri, the multiplier is not likely to be much higher than 2.5.

The reason for a modest multiplier is that much of the new spending is for imported goods and services. For example, much of the food bought at the local grocery store is not grown in the region but is imported from somewhere else. So the \$100 grocery bill that you pay at the store may translate into only \$5 of income to the owner (grocery store margins are razor thin). The other \$95 leaves the region immediately and has no further impact. The same would be true for meals at a restaurant, or clothing from a store. Of course, if the new employees get a haircut, all of that is increased income to the barber, unless, of course, someone travels to another town to get a haircut.

The moral of the story is that the multiplier exists and is an important concept to consider when estimating the likely impact of a new employer, but conservatism is the best approach here. Also note that the multiplier works in reverse as well. The loss of a major employer can be a traumatic experience for a town and its residents. Of course, a lower multiplier works to a town's advantage in this case since the subsequent impact is not as serious if the multiplier is 1.5 rather than 6.

DR: *Many of us remember that economics has a law of supply and demand. All of us, of course, remember it in detail but could you give us a little refresher course? And also, why does government think it plays a role?*

BD: In our economy, the decision to produce goods and services is made by the market.

Demand and supply in the market interact to determine an equilibrium quantity and an equilibrium price for a good or service. As the above discussion indicates, producers respond to sellers by producing more of goods and services where demand is increasing and less where demand is decreasing. This all happens automatically, with no need for government interference. That is, government does not need to tell producers: “Hey, we need more car parts!” The market does that when producers find their inventories depleted and prices rising in response to the higher demand. One of the classic statements in economics happened in France in the Eighteenth Century when a French minister of trade asked a leading businessperson what the government could do to help him, and the answer was “laissez faire,” that is, “leave us alone.”

That is as true today as it was in the Eighteenth Century. It does seem, perhaps, pretty amazing that all those goods find their way to store shelves each day for consumers to purchase. Think



about all that is involved in getting that loaf of fresh bread that smells so good in the bakery.

Some farmer has to grow the wheat, where it is then transported to a mill, which will turn it into flour. A bakery will use the flour and some other ingredients to bake the loaf of bread. If they wholesale the bread, they may then wrap it in a bag manufactured, quite likely, by some other company. The bread is then loaded up for distribution to other retailers. No government officials told the various participants to perform these different tasks; rather, responding to the demand of consumers and hoping to make a profit, they find their niche along the production chain and

contribute to the process of getting that bread to the store shelf while it is still fresh and tastes good.

Basic Vs. Nonbasic Industries

DR: *Are certain types of businesses more valuable to a community than others?*

BD: Government officials and others seem to intuitively know that some businesses are more important than others, and not just because of their size. Regional economists differentiate between basic and nonbasic industries. Basic industries in a region are ones that export their products primarily to the rest of the world (ROW), which is just anywhere outside of the region.

The idea is that these basic industries bring income into the region, which is then spent within the region and it then gets all those wonderful multiplier effects that we just mentioned. Nonbasic industries primarily serve the local population. In Cape Girardeau County, Procter and Gamble (P & G) is a basic industry. While it no doubt sells some of its products locally, most are exported to the rest of the world (outside of Cape County). The individuals who work at P & G earn income that they spend (primarily) in Cape County for local goods and services. Schnucks grocery store, on the other hand, is considered to be a nonbasic industry since it sells its products mainly to individuals who reside within the County.

We sometimes have the tendency to think in terms of actual goods when looking at basic industries, but that would be a mistake. Services can also be basic industries. Consider health care in Cape Girardeau County. With two major hospitals, a plethora of physicians, and other health care providers, many people travel to Cape Girardeau to obtain health care. In a sense then, the County is “exporting” health care when someone from the ROW comes to Cape for those services. Higher education would be another obvious example of a service that is exported by Cape Girardeau County.

We should note that what allows us to label a business as “basic” is the fact that it exports some of its product to the ROW. The size of the business is not particularly important here, except for the final impact. The point is, that even the 10 person machine shop that makes specialty parts for a manufacturer in another region is a basic business that earns income for the region. We should also realize that import substitution can be just as valuable to a region as attracting a new basic industry. Consider Schnucks grocery store again. We noted that it is a nonbasic industry since it sells primarily to people in Cape County. Also note that much of what Schnucks sells is imported into the region. So when someone spends their income at Schnucks, a large portion of that expenditure leaves the region to pay for the imported goods. But suppose that an

enterprising local farmer decides to grow fresh vegetables in the summer that he can then supply to Schnucks. That local farmer now earns an income and Schnucks will import fewer fresh vegetables during the summer. When someone at Schnucks buys fresh vegetables now, it will increase the income of a local farmer (rather than some farmer in a distant region) who can then spend that income in Cape County, generating additional multiplier effects.

What that example illustrates is that import substitution can be as valuable to a region as the attraction of new business. The reason is that a region's imports will be less and its multiplier higher if more locally consumed goods and services are produced within the region and fewer are imported. Economists would say that there is less "leakage" in the spending stream of the region.

DR: *Can you talk further about that? How can we identify basic industries in a region?*

BD: In some cases, it might be fairly obvious. Manufacturing plants typically sell much of their product to the rest of the world. So while many people in Cape Girardeau buy disposable diapers manufactured at P & G's plant, the bulk of the diapers will leave the region. But in other cases, it might be less obvious. It is clear that many people from outside of Cape Girardeau County travel to Cape County, particularly on weekends. Many times, these individuals will eat at a

local restaurant. This means that part of the employment in the restaurant industry in Cape County serves (no pun intended) as a basic industry to the extent that customers are from outside of the region.

Is there any way to determine what portion of the restaurant industry in Cape Girardeau County

Regional economists use location quotient to measure what portion of an industry is considered basic

could be considered part of the county's basic industries? Regional economists have developed a very simple, yet powerful method for making such a

determination. The tool is called a **location quotient** and the idea is simple. If we look at employment, we might find that a certain industry accounts for some percent of the total national employment. For example, the restaurant industry (Food Services and Drinking Establishments is the official title) was 7.9% of total national employment in 2005 according to County Business Patterns, a publication of the U.S. Census Bureau available online. This is found by taking the total employment in the restaurant industry, and dividing it by total national employment. In 2005, Cape County had 3,412 employees in the restaurant industry with total employment of 37,555, or 9.1%. The idea is that nationally, 7.9% of employees in a region are needed to serve the local region. Given the ratio of 9.1% in Cape County indicates that some of the employees in

that industry are primarily serving people from outside of the region and so they can be considered part of the region's basic industries. If Cape County had the same ratio as the nation, 7.9%, there would be 2,854 employees in the restaurant industry in the County. Since there are actually 3,412, we can conclude that 558 employees are actually providing a service for "export."

This concept is very important for a region's officials to understand. There is a tendency to concentrate on industries that are obvious exporters, particularly manufacturing and to think of services as non-basic industries. But these are clearly inappropriate, since even services can be exported to residents from other regions and therefore earn income for the region.

Be sure to watch for Part 4 to be published next month!