Occasional Papers

Small Business and the Globalization of California's Economy

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Thank you for inviting me. My remarks are based on research conducted at the Public Policy Institute of California, an independent, nonpartisan research institute. PPIC does not take positions on legislation, but instead provides objective information for decision-makers and the general public as they consider policy issues.

I will discuss three main topics. First, I will give you the highlights of California's globalization story, concentrating on exports. Second, I will connect this story to what researchers have learned about extending the gains of trade to small firms. Finally, I will discuss trade assistance policy issues unique to California.

A Profile of California's Globalization

California has participated fully in the increased trade and investment that have come to be known as globalization, but the story of that participation is complex. Although California is neither the most globalized nor the least globalized state, a specific pattern characterizes its global economic interactions. California participates strongly in those dimensions of globalization that are among emerging trends.

The highlights of California's globalization can be summarized in five points. First, the state has strong connections with Asia, the most dynamic region. Second, California has a high level of services exports, a new phenomenon in the international economy. Third, its airports are important nodes in global goods movement, and air transportation represents an important new means to import and export. Fourth, California firms engage in production sharing, the manufacture of components and assembly in different locations under the control of one business network. Fifth, California is very strong in manufactured exports, particularly technology goods. Almost all these strengths define the major trends in economic globalization worldwide.

Let me give more details. I measure California's globalization in terms of foreign direct investment (FDI), port activity, and trade.[2] In terms of trade, I will concentrate today specifically on exports. Foreign direct investment is overseas investment for the purpose of controlling a business, such as a grocery store or a computer manufacturing plant. Port activity represents the services that the state's seaports, airports, and land border crossings provide to exporters and importers—not just from California, but also

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[2] See Shatz (2003).

from other states. And trade represents the sale of goods and services to, or the purchases of goods and services from, foreign businesses or consumers.

Compared to the rest of the United States, California has less outward FDI relative to the size of its economy. California constitutes about 13 percent of the U.S. economy, but its firms own only about 8 percent of all foreign businesses owned by U.S. companies. Naturally, this proportion varies by sector – from less than 1 percent in primary and fabricated metals to 20 percent in computers.

Although California's total outward FDI is low, its firms are particularly strong in two of the more dynamic areas of FDI: non-manufacturing industries and manufacturing industries that use production sharing. Production sharing is especially prominent in technology industries and in Asia. California's outward FDI is, as well, strong in the technology sectors and in Asia.

Like outward FDI, the level of FDI by foreign firms in California does not stand out. We can measure this with foreign ownership of property, plant, and equipment (PPE) and with the number of employees in foreign affiliates. Relative to the size of the economy, PPE levels are lower in California than in the rest of the nation, and the level of employment looks much the same as in the rest of the United States.

The industrial mix of California's inward FDI, however, is quite different. California has a much lower share of manufacturing FDI, but the state has a higher share of FDI in wholesale trade; information industries, such as publishing, motion pictures, and data processing; professional, scientific, and technical services; and a group that includes construction and transportation. Once again, in newer areas of globalization, such as wholesale trade and services, California is a leader.

Next we come to ports. California's ports play an important role in U.S. trade. The top two in California for *total trade* are the seaports of Los Angeles and Long Beach, and these have been number two and three in the country in recent years. In fact, they are important for global trade as well. When combined, they form the number three container port in the world behind only Hong Kong and Singapore.[3]

What makes the state a bit different, however, is that its top *export* gateways are Los Angeles International Airport and San Francisco International Airport. Of the total value of exports handled by all California ports in 2002, more than 52 percent moved by air compared to 29 percent for ports in the rest of the United States. In terms of the value of total trade, these two airports have been the seventh and eighth largest ports in the nation in recent years. Again, the goods handled by these ports are not necessarily made in California. Rather, they come from all over the country.

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[3] Containers are large steel boxes that can move on ships, trains, or trucks, and their use starting in the late 1950s has helped expand trade.

Now I will move on to trade, or more specifically exports, the focus of this hearing. I will concentrate on goods exports, although services exports are also important to the California economy. In fact, California's services exports are a larger proportion of its private economy than are services exports relative to the private economy of the rest of the United States. As well, U.S. Export Assistance Centers in California have become known for innovative efforts to increase services exports.

That said, manufactured exports are the stars of California's globalization. Relative to the size of the economy and even to the size of the manufacturing sector, they are far greater than manufactured exports from the rest of the United States. California's manufacturing sector constitutes between 11 and 12 percent of the U.S. manufacturing sector, but California's manufactured exports constitute 15 percent of all U.S. manufactured exports.

California exports are heavily tilted towards high-technology industries. In fact, about half of the manufactured goods that start their export journey from California are computer and electronic products. However, nearly every California manufacturing sector relies more on exporting than do the same sectors in the rest of the United States.

Many California firms do not export goods, but they do provide inputs for products that are ultimately shipped abroad. In one recent year, exports by California manufacturers directly supported 16 percent of all manufacturing employees in the state. But those manufacturers also used inputs from other California manufacturers to make those exports. Adding up the effects of direct exports and the inputs used to make them, exports actually supported almost 28 percent of California manufacturing workers. For the rest of the United States, this figure was less than 19 percent.

Out of 21 manufacturing sectors, ten in California supported a higher proportion of their workers through direct exports than did companies in those same sectors in the rest of the country. However, once again adding up the effects of direct exports and the other manufacturing activity that provided inputs, 17 California industries—nearly every manufacturing sector—supported a higher proportion of their workers through exports than did those same industries in the rest of the United States. Indeed, the effects go beyond manufacturing because other industries are involved in marketing and transporting manufactured exports. All told, manufactured exports supported almost 10 percent of California's private sector employment, compared to less than 7 percent for the rest of the United States. Even if they are not worrying about shippers export declarations or tariff rates in Mexico or Japan, California companies are affected by the health of the international economy.

These findings bear directly on Southern California, which hosts the largest part of the state's manufacturing economy. Under an expansive definition of the region (Imperial, Kern, Los Angeles, Orange, Riverside, San Bernardino, San Diego, San Luis Obispo, Santa Barbara, and Ventura counties), Southern California has almost 63 percent of the state's workers in manufacturing.[4] Like manufacturing workers in California generally, those in Southern California depend on exports for their jobs.[5]

Let me summarize the five points that characterize California's globalization, and then move on to the role of small business in exports.

First, although California's business interests are global, the state is bound to Asia and therefore to Asia's economic health. California's ports ship disproportionately to Asia, its businesses export disproportionately to Asia, and its direct investors place more weight on Asia than do investors elsewhere in the United States.

Second, California sells services to the world, not just goods. Services entered international economic rules only in the 1990s. The California economy is solidly part of this new phenomenon.

Third, California fits into the global shipping industry through its airports, not just its seaports.

Fourth, the world has moved towards production sharing, and California is part of this movement with its outward FDI in Asia, its investment and production in the computer industries, and the trade through its airports.

Fifth, California's manufacturers depend on exports. Although about half of the state's manufactured exports are computers and electronics, nearly every manufacturing industry in California supports a higher proportion of its workers through the state's export activity than do the same sectors in the rest of the United States.

Extending the Gains of Trade to Small Firms

Throughout the United States, small businesses are heavily involved in exports.[6] In fact, they are involved with about 30 percent of all merchandise exports. Likewise, small businesses are a part of the California export story. Small manufacturers make up a higher proportion of all exporting manufacturers in California than in most other states. If you randomly picked a manufacturing exporter in California and one from the other states, the California exporter would be more likely to be a small business.

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[4] This region includes Congressional Districts 20 through 53, except for 21 and parts of 20 and 25.

[5] Data are from the California Employment Development Department (2003).

[6] Much of the information on small business involvement in the international economy for the United States and California is drawn from U.S. Small Business Administration (1998), U.S. Department of Commerce, International Trade Administration (1999 and 2001), and U.S. Department of Commerce, U.S. Census Bureau, Foreign Trade Division (2003).

Furthermore, in Southern California, small business is very involved in manufacturing. Unfortunately, I cannot say with certainty the number of small-business manufacturing exporters in Southern California. In one recent year, however, 59 percent of all workers in manufacturing in the region's major metropolitan areas worked in small businesses, compared to 55 percent for the state as a whole.[7]

Although we often focus on manufacturers that export, most of the small businesses that ship exports are not manufacturers. Rather, they are wholesalers or firms in other industries that facilitate merchandise exports.

These small, specialized businesses are extremely important to the export process. Many small manufacturers do not have the time or staff to investigate markets or carry out the procedures for moving their goods overseas. Therefore, the companies that specialize in export procedures and sales take up the slack, opening foreign markets to California's small manufacturers. When thinking about small businesses and exports, it is therefore important to remember that exporting creates opportunities for small service firms as well as small manufacturers.

It is likely that the number of non-manufacturing small businesses that facilitate exports is very high in California. Because some of the nation's leading ports are in California, other sorts of firms—wholesalers, jobbers, freight forwarders, and third-party logistics companies—are active here.

Therefore, regarding all types of firms involved in exports — that is, manufacturers, wholesalers, and other trade facilitators – almost 94 percent of all the exporters located in California were small or medium-sized firms. Of course, because they are small, the value of their exports is not quite as lofty as their sheer numbers, but in one recent year, they still handled more than one-third of all exports traced to California exporting firms.

Trade Assistance Policy and California

So far I have discussed California's globalization profile, focusing on exports, and the role that small businesses play in that profile. I would like to conclude by discussing how export assistance might help Southern California's small businesses. Although, I do not have specific policy proposals, subsequent speakers who specialize is delivering trade assistance may have specific ideas. Rather, I will present a set of broad principles.

Is there a case for encouraging exports? It has often been noted that exporters are more productive and pay higher wages than non-exporters, but this does not necessarily mean that exporting makes a firm more productive. Recent research has

[7] Data are from U.S. Small Business Administration (2003).

shown that good firms become exporters rather than the other way around. However, exporting does appear to have benefits. In particular, it appears to lead to higher job growth and longer lives for the establishments that export, two characteristics that can bring stability and prosperity to an economy.[8]

Insofar as federal assistance really can help exporters, the environment in California may be extremely inviting now. It looks as if all of California's trade programs have been scuttled under the new state budget, creating a gap in assistance. These California programs included offices that handled export finance and export promotion as well as 12 trade offices in foreign countries. Certainly the efficacy of these programs has been questioned. In fact, research on state policies generally has found few significant effects on the level of overall exports.[9] At times, however, some state programs, including those of California, have been highly praised. Out of the success stories in both the United States and Europe, several principles have evolved regarding small businesses and exporting.[10]

Although there may be an urge to reach out to all small businesses, research questions this approach. Rather, clients should be carefully chosen. This selectivity relates to the issue of whether exporting causes firms to be productive and profitable or whether good firms become exporters. When it comes to assistance, it is important to choose strong firms. Working intensively with all firms that ask for help is not likely to be effective and could even create problems for some firms by causing them to use scarce resources when they are not export-capable.

In working with clients, public-private partnerships appear to be most effective. Examples include export finance guarantees, subsidies or soft loans to hire an export consultant, and collaboration with private groups to identify "export-ready" firms and to train "export-willing" firms. Although the state's programs are folding, there are still plenty of organizations in California that can cooperate to assist exporters. These include the Centers for International Trade Development at the California Community Colleges, four private World Trade Centers, a number of international trade associations, and the network of U.S. Export Assistance Centers. Coordination among these various programs might fill some of the gaps left by the demise of the state's programs.

The division between export-willing and export-ready firms is also useful in designing the specific types of assistance. General educational efforts can teach export-

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8 Bernard and Jensen (1999).

9 See Bernard and Jensen (2001), Coughlin and Cartwright (1987), Simpson and Kujawa (1974), and Wilkinson and Brouthers (2000). Other papers, not cited, mirror these conclusions.

10 See Council of State Governments (2000), Kudrle and Kite (1989), McNiven and Cann (1993), Mittelstaedt, Harben, and Ward (2003), Nothdurft (1992), and Simpson and Kujawa (1974). Interviews with trade officials and other papers, not cited, mirror these conclusions.

willing firms the mechanics of exporting and make them more aware of foreign market opportunities. Carefully tailored assistance appears much more effective with export-ready firms. Among governmental programs, sector-specific programs appear to show the best results. Examples of sector-specific programs include the Energy Technology Export Program of the California Energy Commission, agricultural export programs that numerous states sponsor, and assistance with services exports given by the Services Team of the U.S. Commercial Service.

Summary

California's manufacturing companies ship to foreign markets in a variety of ways. They export directly. They export through facilitators, such as wholesalers or other marketing firms. They also sell inputs to exporters, indirectly depending on foreign markets. Many of California's exporters are small businesses, whether they are manufacturers or trade facilitators. And compared to their counterparts in the rest of the United States, California's manufacturing workers depend more on exports.

Throughout the United States, state governments try to help their small manufacturers export. But in California, it now looks as if this assistance will disappear. Because of the demise of the state's export programs, there may be a rare opportunity for federal agencies to rethink their links to other trade organizations in California in order to help the state's high-productivity manufacturers find new opportunities abroad.

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