Consolidating Gains in a Transitional Economy

Washington isn’t what it used to be. And tomorrow it won’t be what it is today. The pace of economic transformation continues to accelerate. While few now speak of a “new economy” free from the constraints that govern traditional business behavior, it is clear that the economic landscape of this state and this nation have changed dramatically over the last several decades.

To a great extent those changes, which have profound global implications, stem from the productivity and innovation of some of Washington’s leading enterprises. Relatively young firms, Microsoft, Amazon, and Starbucks are globally-recognized, and can take credit for fundamentally altering the way the world does business.

In this WashACE report, we examine some key features of a robust economy in transition and the major public policy issues that will influence its continued growth. The state grew at a strong clip during the 1990s, adding over a half-million jobs, and by 2000 we thought we knew where the future was: the Internet. Then everything changed, with a series of shocks that dragged the state into a deeper version of the national recession. We have emerged from that recession a bit wiser about the pace of technological change, and with a sturdier set of economic drivers.

From the boom of the 1990s through the most recent bust, we have seen the economy lose manufacturing jobs, expand service jobs and continue to evolve in the direction of high value products and services. It is not your grandfather’s economy, but it is an economy that he would feel confident investing in.

THE FUNDAMENTALS

Interviews we conducted with three dozen business leaders from across Washington showed a common blend of optimism and caution. Most attribute the current boom to the strength of the national and international economy, pointing out that we are just following the contours of the business cycle, escalating out of the recession. Still, as one utility executive says, the strength of the economy is “a bit staggering.” And despite the speculation of a few gloomy analysts nationally, there is no local evidence of an impending crash.

The caution stems from the fresh memory of the recession and recogni-
The current pace of growth cannot be sustained.

tion that the current pace of growth cannot be sustained. Economic cycles, by definition, have their ups and downs, and ours may be peaking. For government, these business and civic leaders suggest, it is a time to prepare for the inevitable slowdown: consolidate gains, make prudent long-term investments, and avoid promises that cannot be kept.

From the many perspectives in the interviews we can draw out three positive factors for the state’s economy and three areas of ongoing concern.

**Plus: Technology.** The role of technology in the economy extends far beyond the firms that supply hardware, software and information services. The hidden story about technology is the transformation and renewal of traditional industries. What employment data do not show is the degree to which industries such as aerospace, oil refining, and timber incorporate technology, and the way those new tools are improving productivity across the economy. In Eastern Washington, farmers use sophisticated GPS systems to vary their use of water and chemicals and direct tractors to reduce overlap and inefficiency as they disk their fields. Shipping businesses feed logistically-sophisticated customers a steady stream of information to satisfy the thin tolerances of just-in-time inventory systems. Few businesses in the state operate as they did fifteen years ago.

**Plus: Globalization.** As an executive with a leading multinational firm said, “Our fortunes don’t rise or fall based on short-term fluctuations in Washington.” But even for the state’s largest global enterprises, public policy in Washington continues to matter, and our fortunes will be determined in large part by our continued success in being a platform from which to do business globally. A healthy state economy provides more opportunity for local business partnerships and clusters to develop, makes it easier to extend to new global markets, and facilitates recruitment and retention of talented employees from around the world.

**Plus: Location and quality of life.** Always, executives mention Washington’s celebrated “quality of life” – the beauty, diversity of recreational opportunities, metropolitan sophistication, and unspoiled wilderness. An increasingly important aspect of that quality of life is what one called “the global connectedness” of the state, underscored by a history of “selling planes, books, and coffee around the world.” With deepwater ports, a location “ten hours from Asia and ten from Europe,” an educated and culturally diverse population, and entrepreneurs and political leaders with a passion for seeking new markets and new suppliers, Washington can thrive in the world economy.

**Minus: Regulation and the cost of doing business.** As we found in previous years, business costs and regulation trouble business leaders here. Few cited any progress in tax and regulatory policy. Rather, many of those we interviewed pointed to Washington’s unusually high business tax burden, a problem they did not anticipate would be relieved in the near future, and several identified the new estate tax as a further deterrent to locating in Washington. Similarly, past concerns with the slow pace of regulatory reform remain valid. Housing availability and affordability, transportation improvements, access to a reliable and adequate supply of water, and a stable supply of affordable energy are all affected by regulatory hurdles.

**Minus: Education.** In education, it is important for the state to maintain its commitment to academic standards, improve math and science education, and help ensure that children are ready to learn when they start school.
Interviews showed continued support for Washington’s education reform and accountability program. Of growing concern is the lack of capacity in the state’s four-year university system. While Washington has very high levels of college education within its population, this is due to educated people moving to the state and our own children going elsewhere for their college years.

**Minus: Transportation.** The good news is that we have committed a lot of money to rebuild and expand the state’s transportation system, improve mobility around the ports, and reduce time lost due to traffic congestion. The bad news is that we are not sure of how best to spend these funds. Emblematic of this are the endless debates over the replacement of the Alaskan Way Viaduct and the SR 520 bridge, both of which are vital to smooth operation of the state’s economy. Business leaders still voice a lack of confidence in the ability of transportation agencies to deliver projects.

**OUT OF THE LIMELIGHT**

While our state is participating in the national recovery (and in some sectors leading it), Washington and its leading metropolitan areas have not found their way back to the covers of business magazines and the tops of “best places to do business” lists – territory famously occupied during the tech boom. For a state accustomed to being at the center of national attention, this hurts a bit.

*Site Selection* magazine, for example, failed to include Washington among the top 25 states in its “2005 Top State Business Climate Rankings,” determined by a survey of site seekers and industrial performance data. Nor did the magazine include the state among the “Top Ten Competitive States,” released last May, which relies on data including capital investment, new and expanded facilities, and new jobs.

In an examination of metropolitan regions, Washington cities often show up in the middle of the pack. *Forbes’s* “Best Places for Business And Careers,” released last May, ranks Seattle 101st, behind Bremerton (55th) and Tacoma (80th) and ahead of Spokane (144th) and Yakima (195th). *Forbes* examines job and income growth, business costs, living expenses, and education levels. Business costs, in particular, hurt this state.

The state similarly lags in rankings published by *Chief Executive* and *Inc.* magazines, with *Inc.*’s ranking of Bellingham as the sixth best city in the nation for business being a rare bright spot. (*Forbes* ranked Bellingham 64th and Olympia 29th in its best small places for business ranking.) *Expansion Management* ranked Seattle 17th in its 2006 list of “America’s 50 hottest cities” – the top five were Nashville, Phoenix, Atlanta, Dallas-Fort Worth-Arlington, and San Antonio.

Such rankings invariably blend the subjective and the objective. Different criteria lead to different results. These well-known and highly-regarded publications, however, confirm perceptions often shared by business leaders here: Washington is a high-cost state in a nation characterized by intense interstate competition for new business expansion and location. And, as Governor Chris Gregoire and others have noted, interstate competition may be the least of our challenges in a global economy.

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THE CHANGED STATE ECONOMY

The last decade of the 20th century was a good one for Washington’s economy. Employment grew, industry diversified and Washington solidified its position as a state where innovative companies take root. Then the good times ended with a thud, and it has taken a couple of years for employment in the state to get back on track.

**Job growth on a roller coaster.** Figure 1 shows that from December 1990 to December 2000, employment grew by more than 575,000, or 2.4 percent per year. This was 0.4 percentage points greater than the national growth rate for the period. But that growth was different from the past, reflecting success in diversifying the state’s economy.

Since the dawn of the jet age, the fate of Washington’s economy has been closely tied to employment at the Boeing Company. By the 1990s, however, growth in other sectors had weakened this linkage. The state did avoid the national recession of 1990-1991 due to the strength of Boeing production. But when Boeing experienced two periods of contraction – 1992-1995 and 1998-2000 – neither of those downturns drove the state’s economy into reverse.

Through the 1990s the state was buoyed by the new economy. Companies like Microsoft, Amazon, McCaw Cellular/AT&T and Homegrocer made the Seattle area one of the centers of the high technology boom.

The boom turned to bubble in the late 1990s and, although no one immediately heard the pop, began to deflate in early 2001. Washington employment peaked in December 2000, and by the time of the September 11 attacks on the World Trade Center and the Pentagon, the state had already lost 42,000 jobs. After flying high for a decade, the state’s economy experienced a triple-whammy, as the national recession was intensified by the dot.com bust and the drastic cutbacks at Boeing in the wake of 9/11.

So although the national recession lasted a mere eight months, from March to November 2001, Washington State experienced an intensified and lengthened downturn. Aerospace employment, which had actually grown by 2,000 in the 12 months prior to 9/11, fell off a cliff, dropping 27,000 jobs by April 2004, to a level 52,000 below the industry peak of June 1998. As Figure 2 shows, overall job loss in Washington was sharper than the U.S. as a whole. By March of 2002, Washington employment was
nearly 3 percent below the previous peak, while for the nation employment was down only 1.5 percent.

Washington’s sharp drop in employment during its extended recession has been mirrored by a sharp recovery. Washington’s total employment now stands about 5 percent above the pre-recession peak of December 2000, while national employment is up only two percent above pre-recession levels. Still, Washington’s employment is well below a trend line extrapolated from 1990s employment.

**Seattle and the rest of the state: The tortoise and the hare.** About half of Washington’s jobs are located in the Seattle metropolitan area (King and Snohomish Counties), which is home to most of the state’s aerospace and technology jobs. Figure 3 shows that the pattern of growth in these counties has been quite variable over the past 15 years. Jobs grew slowly from 1990 through 1995, boomed from 1996 through 2000, crashed from 2001 to 2003, and then recovered from 2003 through the present. The Seattle area is just now getting back to employment levels seen in late 2000.

Figure 3 also shows the sharp contrast in growth rates between the Seattle area and the rest of the state. Growth in employment outside King and Snohomish Counties has been much steadier, with the recent national recession appearing to be no more than a slight pause.

When it comes to job growth, the Seattle-area seems to be the hare, losing to the tortoise of the balance of the state. Over the 15 year period as a whole, the average annual rate of job growth in the Seattle area was 0.5 percentage points less than that for the balance of the state. This at least in part reflects the constraints imposed on growth in the Seattle area by the paucity of land available for new housing and industrial development and by highway congestion.

When it comes to incomes, however, the hare is a lot wealthier than the tortoise. Over the 1990-2005 period, average incomes in the Seattle area consistently exceeded those for the balance of the state. Figure 4 shows per capita personal incomes for the two regions relative to the national per capita income. The Seattle area is well above the national average, at times by nearly 40 percent, while incomes in the balance of the state hovered at between 86 and 90 percent of the national average.
For the Seattle area, Microsoft has had notable impact on income. The upward movement in the late 1990s was mostly due to stock options granted to employees and cashed out at the peak of the stock market bubble, while the flip up in 2004 is the result of the extraordinary dividend paid on Microsoft stock in December 2004. Removing these effects still leaves an upward trend over the period, however, with Seattle area personal income currently about 30 percent above the national level. Some, but certainly not all, of the income advantage of the Seattle area is offset by higher costs of living.

Shifts from manufacturing to services. The structure of Washington’s economy follows the national trends away from manufacturing employment and toward service employment. Figure 5 shows that most of the job growth in the state over the past 30 years has been in service industries, which have risen from 54 percent of employment to 65 percent. Figure 6 provides a breakdown of the changes since 1990. Among the four goods producing sectors, only construction has increased its share of private non-farm employment. Employment in each of the other three goods producing sectors – natural resources and mining, durable manufacturing, and non-durable manufacturing – fell in absolute terms, not just as a percentage of the total.

Some of the loss of manufacturing activity may be self-inflicted. The CEO of one manufacturing firm noted that Washington does not offer any special advantages as a location for manufacturing, and that with his firm’s expanded global presence, expansion will almost certainly occur elsewhere.

Aerospace is the largest industry in durable manufacturing, and, as previously noted, is subject to considerable cycles. Aerospace employment hit 115,000 in 1990, fell to 80,000 in
Aerospace employment is on the upswing again. Boeing’s increasing reliance on foreign partners for major airplane components will temper its hiring, however, and few think Boeing employment will ever approach the previous heights. Nevertheless, the jobs that remain pay well and provide a very important piece of the state’s economic base.

As a result of Boeing’s presence, the Seattle area has a deep pool of aerospace labor, and this draws other work. The CEO of an aviation-related firm said that his company’s operations are made easier by the presence of technical skills in the Puget Sound area.

Within the goods sectors, the state’s other traditional base industries have declined somewhat. Logging, wood products manufacturing and paper have lost 3,700, 4,100 and 4,600 jobs respectively since early 1990. Although new technologies will eat into manufacturing employment, a continued supply of timber can keep these industries running strong. According to one timber company CEO, the wildcard in timber supply is the new trend toward ownership of timber lands by large institutional investors rather than by integrated forest products firms.

Primary metal manufacturing has lost 7,100 (largely aluminum) jobs since early 1990. This represents a 58 percent drop. Energy cost and availability is a major factor here. Increased use of “demand response” techniques in energy management, under which large users like aluminum and steel mills shut down operations during times of peak demand, will further challenge primary metals.

In contrast to the goods producing sector, employment in each of the broad service industries shown in Figure 6 grew over the period. The three with the largest percentage increases were information, professional and business services, and education and health services.

Within the information sector, the stellar performer was software publishing, which added 37,600 jobs. With so many of these jobs filled by people recruited nationally or internationally, the key to success for this industry is the state’s continued ability to draw talented people. One software executive noted that issues like commute times, school quality and housing choice make a major difference in the software industry’s ability to lure the talent it needs to continue to grow.

Telecommunications, another information sector, added 5,300 jobs. But as Figure 7 shows, the employment picture differed sharply between wireless carriers, which added 11,900 jobs, and traditional wired carriers, which shed 8,400 jobs. For both segments of telecommunications, the trend in employment broke sharply in late 2000. One telecom executive said that a key to stability in the telecom sector will be ironing out the different local, state and na-
The shift from manufacturing to services is further illustrated in the computer sphere. Figure 8 shows that computer and electrical product manufacturing lost 7,000 jobs over the period from early 1990, while computer system design and related services added 15,600 jobs. Both are down considerably from the peaks reached in late 2000. Computer system design and related services have begun to grow again, while overall computer and electrical product manufacturing employment remains flat.

It remains to be seen whether the state can attract more electronics firms. The CEO of a semiconductor manufacturer said that the state’s B&O tax is particularly hard on his industry, with its thin margins and cyclical sales.

Washington’s medical devices and equipment and biotechnology industries are healthy. Figure 9 shows that, together, they account for about a third of venture capital investment in the state, ranking second and third behind software. According to a biotech executive, a key to attracting further investment in the biomedical sector will be continued availability of the R&D and B&O tax credits.

Aging populations, improvement of technology and greater wealth have all increased the demand for health care. Hospital employment is up 59 percent since early 1990, while ambulatory health care (HMOs, doctors’ and dentists’ offices, etc.) employment is up 64 percent. An executive from a for-profit provider noted that even with this growth and the many challenges facing the sector, the economics of health-care services still favor the suppliers.
While overall financial services employment has grown at the pace of the economy, structural changes lie below the surface. Most notably, banking industry consolidations have eliminated nearly all local ownership of large banks, and have made life difficult for mid-sized full-service banks. One regional executive predicted that the industry will continue to move toward large national banks, a few “super-regional” banks and lots of small privately held local banks.

**Globalization: Causes, impacts, benefits.** Improvements in the technologies for moving goods and information combined with economic liberalization are reshaping the economic landscape, increasing the level of competition world wide. Washington State is in the center of this process, as home to many of the forces driving globalization, as a highly trade-dependent economy, and as a beneficiary of expanded international ties.

The cost of shipping goods by air has fallen dramatically. The Boeing Company is at the vanguard of this change. Similarly, containers, which revolutionized ocean shipping two generations ago, are being packed onto ever larger ships and longer trains, driving down the cost of surface shipping. The biggest impact, however, is not from lower costs but rather much quicker movement of goods through the ports, resulting in faster and more reliable movement of goods. This, in turn, allows the revolution in supply chains.

The Ports of Seattle and Tacoma have been key players in the global shipping and logistics revolution. The ports’ success has been due in part to their strategic location, proximity to Asian ports and links to Chicago and the Mid-West. Expanded activity in the Puget Sound ports is also due to the crowding at California ports, as the dramatic growth in shipping has overwhelmed even those huge facilities.

According to one shipping executive, information technology is increasingly the key to the industry, as customers have become more sophisticated and demanding of timely and accurate service.

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**Figure 10. Exports and Imports as a Percent of GDP**

![Figure 10](image)

Source: Bureau of Economic Analysis
Economists refer to this trade in intermediate products as production fragmentation or vertical specialization. The popular press uses the term off-shoring. The patterns of trade that result from production fragmentation can be quite complex, as illustrated by this example offered by the National Research Council:

Consider the production of an engine for a U.S. automobile for export to Canada. It is more than likely that many of the components of the car's engine will be imported to the United States for incorporation into manufacturer said that improvements in quality of materials from China have led his firm to move from zero imports to 75 percent of inputs originating offshore.

The trade picture in Washington is notable for three reasons. First, the state remains one of the nation’s most trade dependent states, with foreign exports in 2005 totaling $37.9 billion. Figure 11 shows the breakdown of these exports, with transportation equipment (mostly Boeing airplanes) leading the way, at $20.5 billion.

Second, while for the nation as a whole, foreign imports have exceeded foreign exports, the pattern is reversed for Washington State. According to the recently updated Washington Input-Output Model, foreign imports to Washington totaled $21.9 billion in 1997 versus exports of $34.6 billion.

The third notable feature of Washington’s economy concerns those imports. Of the $21.9 billion worth of goods imported in 1997, $17.6 billion worth comprised intermediate inputs or investment goods used by the business sector, while only $4.1 billion was destined for personal consumption. The CEO of a building materials company said that improvements in quality of materials from China have led his firm to move from zero imports to 75 percent of inputs originating offshore.
the engine. These imported goods are likely to be combined with domestically made parts to assemble the various elements of the car engine. In addition, the automobile company may decide to outsource the assembly of the complete engine to a factory in Mexico. Therefore, the company exports the engine parts, which have in them both domestic and foreign value, to Mexico, where they are assembled into the complete engine that in turn is imported into the United States for assembly into the car. The car is then exported to Canada.

Much of the growth in imports and exports shown in Figure 10 is the result of increasing production fragmentation. The global team that Boeing has assembled to manufacture the 787 Dreamliner is perhaps the most prominent local example of this trend.

**The shift to high value products and services.** As societies become wealthier, the mix of goods and services consumed evolves, and this in turn leads to a change in the mix of industrial production. In 1950 agriculture was 6.8 percent of U.S. GDP, manufacturing was 27.0 percent, and services were 46.8 percent. By 2005 the shares of agriculture and manufacturing had fallen to 1.0 percent and 12.4 percent respectively, while services had grown to 66.2 percent. This dramatic shift is shown in Figure 12.

The first thing to note about this trend is that a declining share does not mean that a sector becomes unimportant. While agriculture is a smaller share of overall production in the state, it remains Washington’s second biggest export sector. The value of Washington’s agricultural production reached a record $6.1 billion in 2004. An executive for a food processing firm said that if progress is made on some key water issues, such as storage, almost any field crop can be grown profitably in Washington.

The second feature of the shift in the mix of goods and services is the move to higher value products and away from commodities. Grapes provide a good illustration of this trend. From 1980 to 2005, land devoted to grapes increased from 20,000 to 54,000 acres. During that same time period, wine grapes went from 3 percent of production to 27 percent. The price received per ton for wine grapes is considerably higher than that for juice grapes, and the value of the wine grape crop now exceeds the value of the juice grape crop. The dramatic shift in the state’s grape crop is shown in Figure 13.

The high-value story does not end with the grapes. Much of the grape crop is sent to wine makers in the state, nearly all of whom produce mid-level and premium wines, which command high prices. The wineries, in turn, foster their own tourism industry, which caters to affluent visitors who will patronize high-end lodgings, restaurants and galleries.

Thus, an agricultural sector that began as a producer of low value commodities has evolved into one that supports a network of high value product and service industries. And it will continue...
to expand. A wine industry leader expects to see 500 wineries and 50,000 acres of wine grapes in the foreseeable future.

The same process has taken place elsewhere in the state. Segments of the boatbuilding industry, for example, have evolved from building rugged fishing and work vessels to producing large luxury yachts.

**More brains than brawn.** The final important feature of Washington’s economy that bears some discussion is the role of education, particularly higher education. The preceding discussion provides a nice lead-in: modestly-educated people can grow and squeeze juice grapes, but it takes highly educated individuals to grow premium grapes and turn them into fine wines.

A feature of growing importance to modern economies is the link between earnings and education levels. Figure 14 shows average annual earnings by educational attainment of full time male workers in Washington in 1999 within various age brackets. For all age groups, increases in educational attainment provide increases in earnings. This is due in large part to the globalization factors mentioned earlier, which allow businesses to search the world for low skilled labor, driving down the wages of low skilled Americans.

The slope of the curve relating education to income is becoming steeper, as businesses pay a premium for skills and knowledge that can only be found locally, and refuse to pay high wages for skills that can be found anywhere. The only way to counteract this downward spiral for low wage workers is to increase education levels so that more Americans can offer employers skills and knowledge not found overseas.

In overall education levels, Washington fares better than most states. The 2000 census found 87.1 percent of Washingtonians aged 25 and over were high school graduates (ranking seventh among the states), while 27.7 percent held a bachelors degree (ranking tenth). Only one state, New Hampshire, ranked above Washington in both the high school graduate and the bachelors degree shares.

Figure 15 compares the distribution of educational attainment in Washin-
Washington to that of the nation as a whole in greater detail. For the leftmost four categories, less than fifth grade through high school graduate, the national percentages exceed Washington’s, while for the rightmost six categories, some college through doctorate degree, Washington’s percentages exceed or equal the national rate.

This snapshot of educational attainment is the good news. The bad news is that many of those college degrees must be earned outside of the state. Because the university system in Washington is undersized, compared to the state’s population, employers must rely on out-of-state universities to fill their needs, either by educating Washington students (at a high price) or through in-migration of degree holders.

But adding seats to the state’s university system will be a challenge at a time when the current seats are underfunded. One university administrator notes that the UW has $3,000 to $5,000 per student per year less to work with than its peer institutions.

**POLICY DISCUSSION**

Governor Gregoire often repeats a remark she made upon release of her Global Competitiveness Council report: “Washington is its own small nation in this new world economy.” Her statement emphasizes Washington’s role in an international economic community as America’s second most trade-dependent state. From airplanes and apples to Windows and wine, Washington state businesses compete on a global stage.

At the same time, it is easy to let the focus on globalization obscure a more mundane reality: our state is also in competition with 49 others who vie with Washington to attract new, relocating, and expanding business operations. Often these states offer abundant tax incentives, employee training, cheap land, lower labor costs, good roads, and excellent schools – tangible benefits that compete with the intangible “quality of life” factor that attracts many to the Pacific Northwest.

As good as the state’s economic performance is currently – and it is very good – the remarkably robust economic growth should not lead to complacency. One CEO referred to “sirens of caution” warning of future problems.

Although steadily increasing tax revenues seem to have nullified projections of a budget shortfall made just months ago, recent history will remind us that the good times cannot roll on forever. The reckoning will come. The public policy challenge will be to make the most of the current prosperity to position the state for even more intense competition when the economy cools.
We now turn to what can be done in five critical areas: fiscal policy, transportation, education, energy, and regulation.

**Fiscal Policy:** No Tax Increases Required; Watch State Spending.

Although the state continues to face budget challenges, largely driven by healthcare spending, the June 2006 revenue forecast shows that the strong economy has made it possible for lawmakers to balance the 2007-2009 biennial budget without resorting either to tax increases or sharp spending cuts. Not only is it possible; it is necessary. But even holding the line on taxes and spending this year will not solve our long-term state fiscal problems.

Washington State government currently enjoys a cyclical surplus that masks a structural deficit. Our state’s problem reflects a national pattern. The June 2006 issue of *State Legislatures,* published by the National Council of State Legislatures, reports: “The growing costs of operating programs like Medicaid, corrections, and K-12 education are causing budget overruns in some states. Lawmakers have been able to manage the overages so far this year. But by 2007, 10 expect structural deficits to catch up with them. That number grows to 19 by the end of FY 2008.” The current rate of spending in Washington cannot be sustained as the economy slows down. Without structural changes, we will join the deficit states before the end of the decade.

A utility executive we interviewed puts it this way: the governor and legislature must “continue to prudently manage whatever surplus emerges by virtue of the economic rebound … [and] address long-term problems without bowing to a series of short-term special interests.”

Governor Gregoire regularly cites Priorities of Government (POG) – the budget process pioneered by Governor Gary Locke to address the budget crisis in 2002 – as one of the three points in an accountability triangle that also includes her GMAP (Government Management Accountability and Performance) program and performance auditing. Yet, many of those interviewed believe that priority-based budgeting has not taken hold in her administration.

The next budget will be the first biennial budget for which Governor Gregoire will be fully responsible. It is important that the budget show an appreciation of priorities, accountability, and the consequences of long-term spending commitments. Business rallied behind POG, and now executives say it is time to “revisit or utilize the priorities of government” to put state spending on a sustainable trajectory.

Opinion varies on the use of economic incentives. A biotech CEO, citing increasing interstate competition for technology businesses, puts it bluntly: “If Washington is going to hang on to the companies it has and gain new ones, more than the R&D credit is going to have to happen. I think the ante is going up.” The opposing view is also represented by an executive arguing for a “fair, free, flat” playing field for business. “Who in government knows how to pick winners?” he asks.

Several business leaders, from both publicly-owned and family-owned businesses, urge repeal of the state estate tax. They contend that the revenue estimates associated with it are overstated, as owners will arrange their business affairs to avoid the tax. Furthermore, it will discourage investment in the state.

**Fiscal Policy Recommendations:**

\[ \text{a) Use the Priorities of Government, informed by GMAP, to budget within} \]
available revenues and bring the rate of spending to a sustainable level.

b) Avoid business tax and fee increases, all of which dampen economic activity and reduce productivity.

c) Eliminate the state estate tax if the voters fail to pass Initiative 920.

d) Use economic incentives judiciously to stimulate investment and job creation.

**Transportation:** Continue to invest in transportation improvements, particularly roads and bridges, to promote efficient mobility of goods and people.

Last November, state voters rejected Initiative 912, thus retaining the phased-in 9.5 cent gas tax increase passed by the 2005 Legislature. Most of those we interviewed opposed the initiative and saw its defeat as a sign of overdue progress in addressing the state’s transportation needs. As one executive said, “Finally, after twenty years of not doing anything as one million people moved here, we’re doing something.”

On the 2006 ballot, there may be another attempt to repeal a portion of the 2005 Legislature’s transportation package. Again, business leaders remain committed to carrying out the long-term plan. Yet, they express concern that the state still has not developed a comprehensive plan for addressing several major projects, with the SR 520 floating bridge, I-405, and the Alaskan Way Viaduct in Seattle topping the list. Considerable support was also expressed for regional transportation planning, inter-city rapid transit from Seattle to Olympia (even Portland), and for toll roads.

Despite general business support for increased transportation investment, there is no consensus that the state and local transportation agencies are operating efficiently or have the right priorities. Over the past few years, most acknowledge, there has been steady improvement in performance and accountability, but more remains to be done. Given the magnitude of the infrastructure challenge, it is important to maintain public confidence and momentum.

**Transportation Recommendations:**

a) Maintain the commitment to adequate transportation funding by rejecting Initiative 917, should it qualify.

b) Develop a clear, affordable, and achievable plan for fixing the Alaskan Way Viaduct, SR 520, and I-405.

c) Continue progress at the Washington State Department of Transportation, Sound Transit, and other agencies toward delivering projects on time and budget, with full disclosure and accountability.

d) Recognize the statewide importance of the major Puget Sound ports and concentrate on assuring adequate mobility for substantially increased volumes of goods anticipated in the coming decade.

e) Develop funding plans that incorporate increased reliance on tolls and other user fees.

**Education:** Maintain and enforce learning standards, promote accountability, and increase access to higher education.

As in the past, concern with education dominated many of the interviews. Sev-
Business leaders pushed hard for accountability standards a decade ago and continue to support the Washington Assessment of Student Learning. Business leaders pushed hard for accountability standards a decade ago and continue to support the Washington Assessment of Student Learning. But as they point out, the test, which has become controversial, is not the issue. What matters is the learning, the demonstrated competence, and the test is the essential benchmark. Many cited the results of the spring 2006 10th grade WASL testing, which showed improvement in reading and writing, while revealing disturbing weaknesses in math.

Several expressed strong interest in Washington Learns, Governor Gregoire’s effort to examine, integrate and improve education at all levels, pre-K through graduate school. Without endorsing specific recommendations – a final report will not be available until later in the fall – business leaders support efforts to increase learning readiness, a major thrust of the Washington Learns initiative.

Higher education – access and quality – continues to be seen as integral to the state’s economic vitality. The state’s research universities have spawned several hundred new companies, creating dynamic industry clusters and productive synergies. Our regional state universities and private universities provide outstanding baccalaureate and graduate education. And the community and technical colleges have stepped up to meet the challenges of lifelong workforce training and serving an increasingly diverse community. More and more, the parts of the system work together to create a seamless experience, with programs like Running Start and increased baccalaureate opportunities on community college campuses.

Higher education in Washington, however, faces two weak spots. First is the lack of seats for freshmen in the four-year universities, and the overall lack of capacity to confer bachelor’s degrees. Second is the under-funding of the seats that we do have. The combination of state dollars and tuition currently falls far short of the resources available to institutions elsewhere.

**Education Recommendations:**

a) Hold fast to the WASL standards. Insist on accountability.

b) Pay close attention to the Washington Learns recommendations, particularly with respect to early learning.

c) Allow more flexibility in tuition-setting for state colleges and universities.

d) Continue to fund additional undergraduate positions at the state universities.

**Energy:** Lead with markets and proven technology.

Washington State has had a long history of favorable electric rates and reliable, uninterrupted power, stemming from the abundant hydropower of the Columbia and Snake systems. With the advent of national energy markets and the dim prospects of more dams (it will be difficult enough to keep the ones we have) one of Washington’s key cost advantages is disappearing. But that does
not mean we need to panic and rush into foolish investments or counterproductive regulatory regimes. Rather, we need evidenced-based strategies that will provide adequate energy supplies at the lowest possible cost so Washington can retain what is left of its energy cost advantage. Too many of us remember the WPPS debacle and have no wish to repeat it.

Business needs to watch three unfolding areas of the energy picture. First, there is substantial pressure, especially through a voter initiative, to promote renewable energy sources, especially wind power. While these are coming online across the state and region, they need to prove their technical feasibility and market value and not be subject to mandates. Second, energy planners are putting a huge emphasis on conservation which, while necessary, will not replace the need for new sources of energy. Most of the burden of conservation will be on businesses, and although businesses are already doing an excellent job of saving energy, the pace of future conservation should be dictated by businesses’ investment strategies in plants and equipment, and not heavily mandated. Third, timetables for new generating capacity indicate that we are many years from a substantial increase in base energy capacity (that is, energy that is available regardless of whether the wind blows, the sun shines or the tides in the Puget Sound are running strong).

Energy Recommendations:

a) Let the market dictate the pace and form of investments in renewable energy facilities and in conservation enhancements.

b) Reexamine strategies for conservation and renewable energy to determine if the timetable for new thermal generating facilities should be accelerated.

c) Make energy decisions based on proven, market-tested technologies and management practices, and not on fads or political agendas.

Regulation: Focus on results, don’t micromanage.

Banking and finance, manufacturing, retail, utility, and technology executives all point to problems caused by an excessive and unresponsive regulatory regime.

Business leaders continue to believe the state’s regulatory environment is unfriendly to business. Perhaps even more important, they do not think the regulatory system works effectively to achieve agreed-upon objectives. An executive in a rural county, for example, says that the public participation process has needlessly delayed the county’s ability to adopt its comprehensive plan under the Growth Management Act. A CEO involved with real estate and natural resources says the “onslaught of regulation” in the last fifteen years has created barriers to entry and artificial supply shortages; extended and unpredictable permit processes have led him to “outsource everything we could” and develop out of state.

Regulatory concerns cut across all sectors: banking and finance, manufacturing, retail, utility, and technology executives all point to problems caused by an excessive and unresponsive regulatory regime. Myriad examples illustrate the scope of the problem. The family and medical leave act here differs from other states. Health care mandates are unnecessarily broad. The Growth Management Act increases housing prices and discourages development. The nation’s highest minimum wage, a result of a voter initiative, is too inflexible and particularly hard on agriculture, restaurants, and other service industries. Environmental and labor regulation still seem too focused on telling people how to achieve the desired results, discouraging innovation that may reach the same goals more efficiently and effectively. The state’s workers’ compensation sys-
tem continues to draw criticism for being too skewed against employers. The Department of Labor and Industries, said one manager, writes a lot of rules but “ultimately, policy and paper aren’t the things that keep people safe. It’s what happens on the shop floor.”

This response captures some of the frustration: “Fix the roads. Fix the bridges. Make me pay my taxes. But don’t tell me how to run my business.” A CEO acknowledges the need for regulations and boundaries, but urges state officials to “set goals and let businesses achieve them. Let entrepreneurs at all levels use our ingenuity. If someone wants to step out of the box and do it better, faster, and smarter, let them try it and look at the results.”

**Regulatory Recommendations:**

a) Establish clear regulatory objectives and allow businesses to determine the most effective way to achieve the objective.

b) Recognize that the global economy has accelerated the pace of change; streamline regulatory processes to allow swift decisions and reduce uncertainty.

c) Allow the marketplace to determine compensation and benefits rather than mandate such policies.

d) Examine state labor and environmental regulations to eliminate duplication and determine continued relevance. Promote collaboration and cooperation to achieve the desired results.

**CONCLUSION: NO TIME TO REST ON OUR LAURELS**

With Boeing back at the top of its game, with Washington wines winning awards, and with industry-leading firms across the economic spectrum, it would take a real Eeyore to sound too many notes of pessimism about Washington’s economy. But that is no reason to sit back and relax. Now is the time to concentrate on two key policy directions:

**Invest for the next cycle.** Washington has been a good place to launch new businesses in the past 20 years, and we need to make the investments in education, infrastructure and the business climate to ensure that the next generation of entrepreneurs will want to build their businesses here.

**Avoid the bow wave.** During a hot economy, with its surging tax revenues, lawmakers face pressures to expand programs and launch expensive new ones. The Legislature must be careful to avoid commitments that cannot be sustained in the next downturn, especially if that spending is not directly tied to promotion of a stronger economy.

A state like Washington that welcomes so many newcomers suffers from a collective amnesia: a large percentage of the population has either grown up or arrived since the last major downturn, in the early 1980s. Sooner or later, though, everyone learns that Washington’s economy is not for the squeamish. But if we are smart, the next lesson will not be too harsh.