Thrive WASHINGTON
Strategies to move our state forward

Economic Development:

Moving Washington State Forward Into Recovery

A joint research series from the Washington Roundtable and Washington Research Council

THE THRIVE WASHINGTON PROJECT

The Great Recession dramatically changed fiscal conditions in Washington state, possibly forever. The impact of falling revenues and structural budget deficits has elicited a near universal call for a transformative shift in state government. This research series—developed by the Washington Roundtable and Washington Research Council—will provide actionable state policy recommendations that, if enacted, will preserve essential services, lay a foundation for sustainable economic growth and create an environment in which Washingtonians can thrive.

The slow jobs recovery following the Great Recession has defined a challenging new reality for Washington state. Many old jobs and economic activities will not return. Some businesses will take years to recover; others will never get back to where they were. Still other enterprises have learned that, after restructuring during the recession, they can preserve productivity increases without boosting employment.

Economic development has thus taken on a new urgency.

In this Thrive Washington paper, we examine three factors fundamental to Washington state's efforts to attract and retain jobs and investment: workforce development, the cost of doing business, and direct case-by-case assistance and promotion (casework). The discussion encompasses a review of the public policy rationale for government's involvement in promoting economic growth, what is meant by "business climate," and state and local governments' strategic development initiatives.

RECOMMENDATIONS

1. Increase math and science accountability.
2. Expand STEM education.
3. Re-work higher education funding mechanisms to ensure advancements even under severe state budget constraints.
4. Retain tax incentives.
5. Add economic development criteria to state infrastructure programs.
6. Enact tax increment financing and improve other value-capture tools.
7. Coordinate economic development efforts statewide and align them with state goals.
8. Focus more on industry and talent clusters.
9. Create public/private industry promotion mechanisms.

The Context for State Economic Development Programs

As long as governments build infrastructure, govern and fund education systems, and regulate environmental and employment practices, they shape economic growth and investment. Pro-active economic development programs generally focus on job growth, increased productivity, and long-term sustainability. Clearly not mutually exclusive, these goals nonetheless drive different strategic initiatives.

Washington is among a small number of states that have experienced both high population growth and high productivity growth during the last decade. The state grew 14 percent between 2000 and 2010, ranking 13th nationally. In 2009, per capita GDP in Washington stood at $50,467 (11th highest in the nation). Only two small states—Wyoming and Delaware—have both higher per capita GDP and higher 10-year growth rates than Washington. The challenge for Washington is to retain its dominant engines of economic growth, encourage their expansion, and develop new, high-growth, high-productivity industries.

Components of an Economic Development Strategy

Most economic development activities address workforce development, business climate and costs, and casework. The Washington Roundtable's Benchmarks for a Better Washington (www.waroundtable.com/benchmarks) assess our state's progress against other states on key education, infrastructure, and business cost factors. These include student performance in math and science, the number of bachelor's degrees awarded per capita, the percentage of roads in good condition, and unemployment insurance tax rates and workers' compensation benefits paid, among others. Previous Thrive Washington papers have taken in-depth looks at how the state's unemployment insurance and workers' compensation systems drive business costs, as well as the need for Washington to enact sustainable budgets and implement responsible regulations.

Washington state:
high population growth and high productivity growth

Population grew 14% between 2000 and 2010
(13th highest in the nation)

Per capita GDP in 2009 was $50,467
(11th highest in the nation)

In 2009, Washington was 13th among the states in the percent of population 25 years or older who had completed an advanced degree.

Education and Workforce Development

Education—from pre-K through post-doctorate programs—plays the single most influential role in helping Washingtonians reach their highest potential and ensuring the state's citizens are prepared for the job opportunities that will exist here.

State government defines and shapes the education system. The state funds and sets standards for K-12 education and directly operates most of the higher education and workforce training capacity of the state, including community colleges and four-year institutions. In the innovation economy—indeed, in all sectors—workforce quality is a key factor in state competitiveness.

Measured by educational attainment, Washington is highly competitive. In 2009, according to the U.S. Census Bureau, Washington was 15th among the states in the percent of population 25 years or older who had completed high school, 11th in the percent of total population that had earned a bachelor's degree and 13th in the percent that had completed an advanced degree.

However, the state workforce's above average educational attainment has relied in part on highly educated people moving to Washington. The state's Office of Financial Management estimates that between 2000 and 2010 about 460,000 more people moved to Washington than moved away, accounting for more than half of the state's population growth.

The ability to attract highly mobile talent by providing career opportunities and a high quality of life is a positive sign for Washington. But the state cannot rely on in-migration to fill its workforce needs. The state's educational system—and its ability to educate and prepare its young people—will be the key determinant of the future depth and breadth of the state's workforce.

Public Schools

Every public school student in Washington state should graduate from high school prepared for the rigors of college and the workplace. Unfortunately, that is not the case in our state today. Too many of Washington's students do not finish high school and far too many of those who graduate do not have the skills and knowledge needed to succeed.

Nearly
29,000
Washington students fail to graduate
from high school every year.

- Nearly 29,000 students fail to graduate from high school in Washington state every year; this equates to 161 students dropping out every school day.
- Washington's high school graduation rate in 2007 was 67.9 percent, ranking the state 35th in the nation. To rank among the top 10 states, as called for by the Washington Roundtable's Benchmarks for a Better Washington initiative, at least 80 percent of Washington's students must graduate from high school.

Washington's high school graduation rate in 2009 was
67.9 percent
— 35th in the nation.

- Washington ranks 46th in the nation in terms of the likelihood of a student being enrolled in college by age 19. Less than half of high school students have even completed the necessary credits to apply to a Washington state four-year college. Lack of sufficient math credits is the biggest barrier to college for most students.

The data on high school graduation and college enrollment rates is particularly distressing given the fact that some form of post-secondary education is increasingly a necessity for any young person who hopes to secure and enjoy a family wage job in our state. By 2018, 67 percent of jobs in Washington are projected to require some form of post-secondary education.

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Math and science are the subjects where proficiency will most likely determine future success. Yet these are also the subjects with which students struggle the most. Washington ranks ninth nationally in 8th grade math scores (with 39 percent scoring at or above proficient) on the National Assessment of Education Progress (NAEP) and 21st in 8th grade science scores (with 34 percent at or above proficient).

Promising efforts are underway to improve math and science education in Washington state. The private sector has heavily invested time and resources to develop and launch Washington STEM, a nonprofit organization dedicated to advancing science, technology, engineering and mathematics (STEM) education. Washington STEM will utilize private donations to discover and develop best practices, develop education capacity, engage parents and communities, and create innovative policies to advance STEM education. The state should support Washington STEM efforts and prioritize investment in programs that will prepare students for careers in STEM-oriented fields.

Placing a laser-like focus on graduation rates and student proficiency in math and science will not only improve the number of students who earn a high school diploma, it will ensure they graduate prepared to take the next step in life—be it in a trade, apprenticeship, community college or university—and take advantage of the opportunities available in our globally competitive, innovation economy.

Higher Education

As noted earlier, Washington's economy is increasingly driven by innovation and the state's workforce is among the most highly educated in the nation. Yet, Washington ranks 35th in the nation in the number of bachelor's degrees awarded per capita.

Expanding higher education enrollments is critical to creating opportunities for Washington students and the state's economic future. In our education system, Washington ranks **35th in the nation** in the number of **bachelor's degrees awarded** per capita

the community and technical colleges play an important dual role as well—serving as the gateway to a four-year degree for many students, while also providing others the essential skill development for workforce success.

A top ranking among the states in the number of bachelor's degrees awarded per capita indicates a higher percentage of the population prepared for career success and stronger economic prospects for our state. To become a top ranked state, Washington must develop a more stable long-term funding framework, accompanied by clear accountability for results.

Governor Chris Gregoire's Higher Education Funding Task Force released its recommendations in early 2011. The Task Force proposed that the state give public four-year universities more tuition flexibility; establish an endowment for Washington Pledge Scholarships that would be managed by a non-profit and funded with both state and voluntary private contributions; strengthen university accountability; and increase the number of graduates, especially with STEM-related degrees. Enacting these recommendations would provide more stable and predictable long-term funding and improve retention and graduation rates. This is important throughout the higher education system, particularly in high demand programs and STEM related fields.

Business Costs: Taxes and Infrastructure

Washington businesses paid $14.7 billion in state and local taxes during the 2009 fiscal year (51.2 percent of all tax receipts).

Site selection consultants and corporate executives frequently identify Washington as a high-tax, highly-regulated state. Having previously addressed employment cost drivers in another paper in the Thrive Washington series, we now concentrate on tax policy and infrastructure.

The Benchmarks for a Better Washington paint a mixed picture of Washington's competitiveness on tax and infrastructure metrics. The state's effective tax rate on business is 13th highest in the nation. On the other hand, thanks to an abundance of hydroelectric power, Washington's electricity rates are the lowest in the nation at 5.95 cents/kWh. Washington has a higher percentage of functionally obsolete bridges than 41 other states, but Washington ranks 16th in the nation in the percentage of roads considered to be in good or very good condition (48.2 percent). The state ranks 39th in commute travel times.

Taxes

State policies affect the direct cost of doing business on many levels. Businesses pay property and sales taxes, as well as Business and Occupation (B&O) taxes. Employers must contribute to unemployment insurance and workers' compensation programs. Many businesses are directly regulated or licensed by the state. Although no single tax or regulation (generally) will make or break most businesses, the cumulative impact contributes to a sense of whether or not the state is a welcoming place to do business.

The Council on State Taxation calculates that businesses paid Washington's state and local governments $14.7 billion in taxes during the 2009 fiscal year (51.2 percent of all tax receipts). The effective tax rate on business in the state (calculated as the ratio of taxes to private sector gross state product) was 5.3 percent, tied for 13th highest in the nation and six tenths of a percentage point greater than the 4.7 percent national average.

The business tax burden would be considerably higher were it not for a number of tax preferences: exemptions, deductions, deferrals, credits and special rates. In addition to lowering the overall tax burden of business, preferences play special roles in normalizing the tax structure. Although they are sometimes referred to as tax incentives, more often than not they serve to offset tax disincentives that discourage economic development. This is especially the case with respect to preferences related to sales taxes on business input purchases and the B&O

TOP TAX PREFERENCES FOR ECONOMIC DEVELOPMENT, 2007-09			
	Tax Savings (Dollars in Thousands)		
	State Taxes	Local Taxes	Total Taxes
Sales tax on manufacturing machinery	$422,353	$130,929	**$553,282**
B&O reduction for commercial airplanes	$150,332	$0	**$150,332**
Sales tax on high technology equipment	$102,924	$31,906	**$134,830**

In 2009, the value of transactions subject to the B&O tax was more than four times the value subject to the sales tax ($416.6 billion versus $100.4 billion).

tax, which together account for nearly one-half of the business tax burden.

Of the tax preferences that the Washington State Department of Revenue places in the business incentive category, the three with the greatest savings to taxpayers are the sales tax exemption for new or replacement machinery used in manufacturing operations, the preferential B&O tax rate for manufacturers of commercial airplanes or commercial airplane components (0.2904 percent rather than 0.484 percent for manufacturing generally), and the sales tax exemption for the construction of buildings and the acquisition of machinery and equipment for high technology research and development.

Each of these preferences removes significant tax disincentives. The equipment and machinery sales tax exemptions for manufacturing and high technology research and development avoid taxation of critical inputs to production processes. The 0.2904 percent B&O rate for commercial airplanes was provided in recognition of the fact that as Boeing increased the degree to which it outsourced major components of its aircraft, the effective tax rate it faced for manufacturing in Washington increased.

Tax policy experts generally perceive the sales tax to be a tax on consumption and agree businesses should not pay sales tax on input purchases. Indiana University economist John Mikesell expresses it this way: "Full exclusion of all production inputs from state sales taxation is consistent with ideas of efficiency that should drive tax policy in a market economy." Sales taxes on business inputs pyramid—they build up haphazardly through the various stages of the production process, creating inequities between businesses in the amount of sales tax embedded in their products. These sales taxes distort choice among production processes.

When capital purchases are subject to sales tax, businesses have less incentive to invest in new equipment, machinery and structures. The reduction in investment impedes labor productivity growth and, ultimately, wage growth. Sales taxes on input purchases distort decisions about whether to produce various components in-house or outsource. Finally, sales taxes on input purchases put businesses in our state at a disadvantage against competitors operating in states that tax fewer business input purchases or that have lower sales tax rates. The liberal Institute for Taxation and Economic Policy concludes that "the exemption from the sales tax of most purchases made by businesses is actually good policy."

Washington's effective tax rate on business is **13th highest** in the nation

The B&O tax is in effect a very broad sales tax. In 2009, the value of transactions subject to the B&O tax was more than four times the value subject to the sales tax ($416.6 billion versus $100.4 billion). Mikesell observes, "No sensible case can be made for imposing gross receipts taxes [such as the B&O tax] in the modern economic environment."

Because of the large base, the B&O tax leads to severe pyramiding problems. The tax is not sensitive to a business's ability to pay, so low-margin businesses pay much higher effective tax rates than high-margin businesses.

The Washington State Tax Structure Study Committee found: "Our B&O tax is a dramatic violator of the principle of neutrality among like businesses. The pyramiding of this tax on goods as they move through the production chain is a fundamental problem that requires correction." Many of the tax preferences associated with the B&O tax serve as rough corrections for these problems.

Infrastructure

Infrastructure quality and capacity have major impacts on the cost of doing business. The transportation network affects the recruitment and quality of life for employees and the ability to move supplies, products, and service vehicles. Many businesses use water and power intensively, making utility rates an important cost driver as well.

Despite these impacts, infrastructure funding programs rarely have economic criteria built into their decision-making processes. Nevertheless, Washington has a number of options for funding infrastructure that contribute to economic development. The Public Works Trust Fund provides low interest loans to local governments to expand infrastructure to accommodate new industries. The Community Economic Revitalization Board (CERB) provides loans and grants to local projects designed to spur job growth, primarily outside the major metropolitan areas. These programs are relatively small, however, and finding funding for major projects is difficult.

One reason is that the state's constitution generally restrains the use of public dollars to attract businesses. Although the state has some limited ability to provide direct financial aid to businesses, lending of credit and gift of public funds restrictions have always hampered such programs. The two most general programs—community development block grants and industrial revenue bonds—are based on federal assistance that is not restricted by the state constitution, but which is limited and probably shrinking. Other programs, such as the forest products revolving loan fund or the coastal revolving loan fund, are quite narrow in application.

That said, since the 1970s, the state has gradually opened up the use of government funds for economic development as long as there is an appropriate "public purpose." The CERB operates under this public benefit definition. But even with some loosening, the provision of direct aid to prospective employers remains more the exception than the rule.

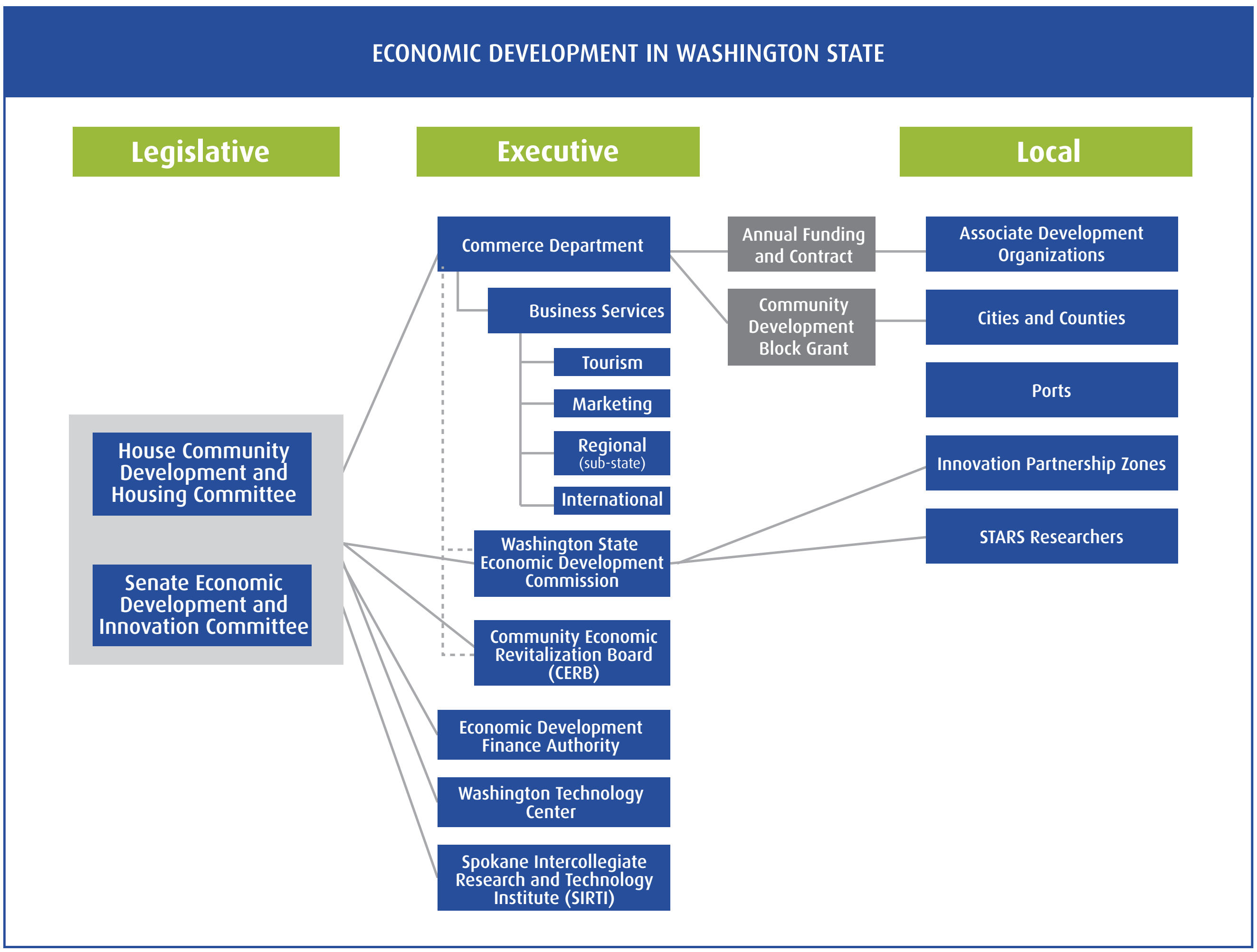
One option unavailable to the state is tax increment financing (TIF). Under TIF, the increased property tax revenue that results from improvements in a certain district is captured to pay for the infrastructure that made those improvements happen in the first place. Nearly every state in the country has this capability, but in Washington, TIF has been deemed unconstitutional. Several measures are on the books, notably the Local Infrastructure Financing Tool (LIFT) and the Local Revitalization Financing (LRF) program, but they have had only limited applicability.

A new approach to TIF was introduced during the 2011 legislative session. The proposed mechanism would allow jurisdictions to impose an additional property tax on the increased value of property within the TIF district, rather than use existing taxes. The proposal also includes a constitutional amendment to exempt these new taxes from constitutional limitations.

Casework: Direct Efforts to Attract and Retain Business Investment

A direct form of economic development work—attracting and retaining businesses using a variety of incentives—is important. As long as businesses, whether already located in Washington or considering locating here, can shop the world for places to grow, the state's capacity to respond to their requirements could be the decisive difference.

In the use of direct incentives, Washington operates with specific constraints that put the state at a competitive disadvantage. The state constitution (article 8, section 7) directs that no government in the state may "give any money, or property, or loan its money, or credit to or in aid of any individual, association, company or corporation, except for the necessary support of the poor and infirm." This provision makes it difficult to compete with states that provide direct assistance to businesses, such as the free land Amazon is being offered to set up a warehouse in Tennessee. In light of this challenge, Washington must pursue



The governor should take the lead in promoting the Department of Commerce as the state's flagship development organization.

an even more comprehensive, strategic and coordinated approach to economic development.

In 2008, the Washington Economic Development Commission asked agencies across the state to report their economic development activities. The responses suggest both fragmentation and attempts to link even merely tangential activities to development: 42 organizations reported back, listing 143 programs with total funding exceeding $3 billion.

More than half of the reported $3 billion falls into the category of "human potential." The largest part of the human potential category is the half-billion dollar WorkFirst program operated by the state Department of Social and Health Services to help people move from public assistance to the workforce.

To bring more focus to state efforts, in 2009, the legislature directed the Department of Community, Trade and Economic Development to reorganize itself into a new Department of Commerce. This process resulted in a new long-term strategy and brought focus and coordination to the department's marketing and casework efforts. While Commerce does not have operational control of myriad state and local infrastructure and business assistance programs (see organization chart on page 7), the reorganization properly recognizes the importance of a high profile, focused statewide economic development organization.

For many firms considering expansion or relocation, Commerce will be the portal to entry. Although a variety of local and regional factors within the state influence investment decisions, the policies and practices of state government exert the greatest influence and offer the greatest promise for successful development efforts. The Department of Commerce uniquely strengthens and extends the reach of the various recruitment and retention efforts of local development groups. Because development anywhere in the state benefits the entire state, Commerce complements sub-state efforts; it does not compete with them.

The more unified and focused the state's casework strategies become, the more effective they will be. The governor should take the lead in promoting the Department of Commerce as the state's flagship development organization. As Washington's chief executive, the governor represents the state to the world. Successful competition in the global economy requires sharply defined goals, close coordination with local and regional development groups, and the cooperation of legislative and community leaders. Most important, it requires the focus and discipline most effectively channeled when Commerce is recognized as the leading economic development agency for the state, not just state government.

Sustainable Growth Strategies

In recent years, states and regions have become more strategic about economic development in the face of global economic change. Strategies include targeting innovative "new economy" enterprises, embracing globalization, and developing industry clusters. (Michael Porter of the Harvard Business School unleashed the cluster concept in the 1980s. Following his lead, states and regions have embraced the idea of attracting not just single factories, but the entire ecosystem that surrounds an industry.)

Washington has undertaken all of these strategies in earnest. The state has benefitted from the development of aerospace, IT and food processing enterprises and shows promise in clean technology and materials industries. Washington has long been an international gateway and is the most trade-dependent state in the nation. State and local organizations have actively promoted globalization, beginning with the Washington Works Worldwide report in 1988 and the creation of the Trade Development Alliance in 1992. Most economic development plans in the state, including the four-county plan of the Prosperity Partnership, have taken a cluster approach.

A recent analysis by Porter places Washington in the top quintile for productivity and innovation, and reports that the state's leading clusters are information technology, distribution services, aerospace vehicles and defense, entertainment, and agricultural products. Washington's traded wage is higher than the national average, and most of the difference is driven by the state's cluster mix (although the wages in Washington's clusters are also higher than national wages in those clusters). Washington ranks 14th in the nation in the share of employment in traded clusters (29.2 percent), meaning those clusters that serve other markets and are consequently free to choose location.

Steps to More Effective State Economic Development

Washington must maintain and enhance its investments in workforce and infrastructure, control business costs, and focus its retention and recruiting efforts to achieve the maximum return on limited investment.

Education and Workforce Development

- Increase accountability for results in math and science education. The legislature should stop deferring the assessments required to ensure high school graduates are prepared for successful entry into postsecondary education or the workplace. Additionally, the legislature should adopt and fund the State Board of Education's new graduation requirements, aligning them with the Higher Education Coordinating Board's (HECB) minimum admission requirements.

- Expand STEM education. Improvements can be made across the board in the state's massive education and training portfolio. The most immediate concern is the state's poor performance in educating an adequate workforce to meet the demands of our growing STEM fields, making the state's businesses highly dependent on out-of-state recruiting. The HECB has set targets for expanding STEM degrees, and the legislature and the four-year universities need to follow-up on those goals and ensure that they are met.

- Re-work higher education funding mechanisms to ensure success even under severe state budget constraints.

Washington must maintain and enhance its investments in workforce and infrastructure, control business costs, and focus its retention and recruiting efforts to achieve the maximum return on limited investment.

Business Costs

- Retain tax incentives. Business tax incentives help smooth out our tax structure to ensure it works properly. They act to lower the burden on investment and job creation, making Washington a more attractive place in which to operate.

- Add economic development criteria to state infrastructure programs. While economic development is the central criterion for funding from the CERB, other programs do not focus enough on the potential positive economic impact of projects applying for funding. For example, the Transportation Improvement Board, which funds $50 million per year in local transportation projects, has almost no economic development criteria for project selection.

- Enact TIF and improve other value-capture tools. In the 2011 session, the legislature is once again grappling with TIF. Lawmakers should enact legislation that addresses the concerns of jurisdictions, such as school and fire districts, that fear the erosion of their tax bases. Lawmakers should also consider mandating that local governments adopt latecomer processes (in which the first developer pays all improvement costs and is reimbursed by later arrivals for their share of the costs) and provide mechanisms to help administer and track those agreements over time.

Specific aspects of economic development that are especially helpful in attracting and retaining business are workforce development, business climate and casework.

Casework

- Coordinate economic development efforts statewide and align them with state goals. The governor should take the lead in promoting the Department of Commerce as the state's flagship development organization. Success requires sharply defined goals, close coordination with local and regional development groups, and the cooperation of legislative and community leaders.
- Focus more on industry and talent clusters. Generally, we organize ourselves by function—infrastructure, education, recruiting—or by geography. But by their nature, clusters have cross-functional needs and do not respect geographic boundaries, making it challenging to organize strong strategies. Strategies should be built around target clusters, and resources provided across agencies and geographies. The Washington Aerospace Council, which brings industry, labor, economic development and workforce agencies together, provides a model for policy coordination at the state level.
- Create public/private industry promotion mechanisms. Complementing a cluster focus should be the creation of industry-based groups to lead the cluster efforts, similar to the way crop commissions promote agriculture in the state. Many of the pieces are already in place. Clusters are already organized around private groups such as the Technology Alliance, the Washington Clean Technology Alliance, and the Global Health Alliance, and much of the industry promotion activity of Commerce is already conducted through private funding.

Conclusion

Economic development is an inherent part of most state activities. Specific aspects of economic development that are especially helpful in attracting and retaining business are workforce development, business climate and casework. There is reason for optimism on all three.

Public and private groups have made proposals that would enhance the education of our students to ensure they are prepared to enter the workforce. The legislature recently enacted long-overdue reforms to the state's unemployment insurance program. Such actions will help bring Washington's costs of doing business to a more competitive level. The state's casework activities have embraced the innovative industries and clusters that are a draw for other businesses.

By continuing such work, Washington's economic development work can help push the state forward into recovery.

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