# THE WESTERN ECONOMY IN TRANSITION:

# A SUMMARY

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This summary was prepared by WGA staff and is based on work done by Bernard L. Weinstein, Ph.D. and Harold T. Gross, Ph.D. entitled The Western Economy in Transition: Nature, Causes, and Implications. The complete work is available from the Western Governors' Association upon request.

## INTRODUCTION

Since the first fur trappers, miners and homesteaders headed westward, the economy of the West has gone through cycles of boom and bust, determined largely by circumstances beyond its control. The period from the early 1970s to the present has continued this pattern, with energy, mining, forest products, agriculture, and high tech industries booming in the 70s and stumbling severely in the 80s. Though the value of the dollar, materials substitution, and foreign production are not things which western governors can control, the response to those changes is something they can affect.

This report is a baseline snapshot — what the West is like, what's happening to the region, what can be built upon. It is clear that the western economy has problems. It is also clear that the West has strengths and opportunities. The governors will combine the findings from this paper with the findings from the other reports of the Western Agenda to develop a program to help economic sectors which are being affected by permanent change build on their strengths, support and expand existing businesses, encourage growth in areas where there are gaps, and direct the efforts of all westerners to work together to take advantage of the next turn of the cycle.

## PROFILE

Population growth rates in the West are slowing. After nearly two decades of extremely high levels of growth, increases in population between 1984 and 1985 in almost all the western states except those in the Southwest (Arizona, California and Nevada) are starting to resemble the national growth rates. While many states will stay slightly above the norm* the explosive growth of the 1970s will probably not be repeated in the foreseeable future.

*The terms norm, average, and mean in this report refer to comparisons to national figures.

The reason that population increases will remain slightly above the national average is that most western states, with the exception of the High Plains states, have a relatively young population with a higher percentage of their female population in child bearing years. The reason that extreme population growth rates will not be repeated soon is that in-migration from other regions is declining. Nationally, as the baby boom generation grows out of its twenties and thirties, the tendency to pick up and move decreases, resulting in lower migration rates. Net migration in the West accounted for nearly half of the population increase in the region between 1980-1984.

Contrary to popular belief, the West is a relatively urban region with nearly two thirds of the population living in the region's fourteen largest metropolitan areas. However, this aggregation obscures the "two Wests" — all the northern tier states except Washington have a smaller portion of their population in metro areas and all the southern tier states except New Mexico have a larger portion of their population in metro areas compared to the national average.

Most western states have a relatively young population. All but two western states have higher than average percentages of population under 14 years of age and only five states have higher than average population representation in the over 65 age group. The region's population is predominantly white with no state approaching the national average of twelve percent black representation. The states of California, New Mexico, Arizona and Colorado have large and growing Hispanic populations and Hawaii has a population composed largely of Japanese, Filipino and other Asians as well as Pacific islanders. The education levels are above average with only one state in the West having a smaller than average level of high school graduates as a percent of the adult population.

Almost every western state has a high percentage of homeowners compared to renters. The region is also characterized by relatively new housing stock. However, as the high levels of in-migration which fueled a strong construction market wanes, the housing industry will begin to resemble national cyclical patterns.

Changes in per capita income levels, which many people use as a measure of relative economic activity, show a mixed picture in the West. Five states posted above average gains between 1978-1980. Six states experienced above average growth between 1980-1982 with only two states repeating from the 1978-1980 period. With the downturn in agriculture and natural resource production, <u>only three states in the West were able to record above average per capita income growth between 1982-1984</u>. As a result of declines in states' economies, state tax revenue (adjusted for inflation and population changes) decreased in seven western states between 1984 and 1985 and another five states grew below the national average.

It is not merely coincidence that the <u>states that have had the most stable per capita income growth are those least dependent on agriculture and natural resource production</u>. Those states, including California, Arizona, and Colorado, all have relatively robust and growing manufacturing and service sectors. In fact, between 1980-1985, the service sector was the only sector that grew in all sixteen western states while manufacturing employment, which declined nationally, grew in eight western states. While many of the new service sector jobs are low paying positions that will never replace the high wage rate mining and construction jobs, other new service jobs are in relatively high paying business related services such as legal and computer services. Even with the growth in manufacturing employment, every western state has below average employment in this sector.

In summary, although the western region is comprised of states of vastly different character and economy, the West in the mid 1980s is relatively young, relatively well educated, predominantly white (with important clusters of Hispanics and Asians), with above average tendency toward homeownership, clustered in major metropolitan centers. It is a region whose population growth rate is moving toward the national mean and whose traditional industries of agriculture and natural resources production are in decline and helping to cause declining relative per capita income levels and declining or anemic tax revenue growth.

EXTERNAL FORCES

Many external forces help shape a state economy. Western states know this perhaps as well as, if not better than, their eastern and southern counterparts. To begin with, over half of the western land area is owned and managed by federal agencies. Secondly, the two traditional industries of the West, natural resource production and agriculture, have become increasingly subject to the influence of international events.

The federal government (in addition to its decisions on mining, drilling, timber harvesting and grazing on federal lands) plays an important role in many western states' economies through procurement contracts, military bases, and federal labs. In 1985, $65 billion in federal military contracts and payroll flowed into western states. This figure represents nearly one third of all federal dollars for these expenditures. Adding in spending by contractors and the multiplier effect of spending by Defense Department employees, the benefit to the region in 1985 increases to $117 billion. Therefore, decisions in Washington, DC on the defense budget will have direct, important, somewhat cyclical effects on western state and local economies.

In the 1970's, the high inflation rates pushed commodity prices up faster than fabricated products. Now in the mid 1980s, a somewhat deflationary period is occurring leading to relatively faster rising prices for fabricated products. What had been a period of transfer of real income from the eastern U.S. to the West has now reversed.

Mining (loosely defined to include oil and gas production) has been a major source of jobs, income, and tax revenue for many western states for a number of years. In 1972 when the OPEC cartel forced the price of oil upward, both oil and gas producing states and coal states benefited. Conversely, when overproduction in world oil markets began to force prices down in 1984-1985, these same states felt the reverse impact. Jobs were lost, along with their high level wages, and tax revenues began declining.

Some of the changes in this industry are cyclical while others are structural. As prices for oil go down, demand will rise which will take up the slack in over-production and force prices back up. However, long-term conservation efforts may lengthen the cycle, and the sharp rise in construction of modern refining facilities abroad could permanently shift refining jobs to other countries. Coal should recover along with oil and gas, but uranium mining is unlikely to rebound in the foreseable future. Mining of hard rock minerals is going through even more severe structural changes, both because of competition from abroad and because components of fabricated products are shifting toward plastics and other synthetic materials. The only true bright spots in the mining industry are for strategic minerals and precious metals. Uncertainties engendered by unstable governments throughout the world combined with the West's relatively large reserves could provide new jobs in the years ahead.

Several of the energy producing states did legislate trust funds into which they put a portion of the energy tax revenues they collected during the "boom" years and used some monies to improve the public infrastructure. These states will be able to draw on those funds to help moderate the most severe consequences of the downturn and to try to diversify the state's economy.

The agricultural sector is suffering from a litany of well publicized woes: declining land values, a strong U.S. dollar (until recently), federal programs that do not always work as intended, excessive indebtedness, and overproduction to name only the primary problems. American agriculture is dependent on export markets for the sale of 35% of harvest. For some states in the West, the percentage dependence is much higher because the primary crops produced are much more reliant on export markets (e.g., wheat = 60%). Many markets which were lost in the last three years as a result of the strong dollar will not be regained because of significant increases in global production. Ag producers in the U.S. face new competition as developing countries are cultivating more land and are not only providing for themselves but are now entering the export market.

Despite these problems, American agriculture remains the most productive in the world. Furthermore, the federal government has rewritten farm support programs to help bring down the price of U.S. ag exports over the long run, the strength of the dollar is waning, interest rates are much lower, and the price of oil is down. All these events combined will help bolster the agricultural sector. The future strength, and perhaps salvation, of the agriculture industry in the U.S. will be with improved marketing strategies, development of improved financing, utilization of technological advances, the diversification of crops to include specialty crops, and increased export of processed foods.

Other major sectors of western states' economies are facing changes. Forest products are being hurt by competition from domestic and foreign products and by materials substitution. Fisheries also are facing increased competition. Fortunately aerospace and defense related industries have provided somewhat of a cushion for the declines in these two areas. High-tech manufacturing, which includes the application of high tech processes in general manufacturing, has found stiff competition from abroad but part of the downturn is cyclical while another part is controllable through actions to increase competitiveness. The West, with its entrepreneurial spirit, relatively young, well-educated, urban population, and opportunity to establish a new state-of-the-art manufacturing sector to diversify its economic base, may want to look in this direction for its future growth.

In summary, many of the external forces which have major influence on most western state's economies are currently combining simultaneously and heading in a "negative" direction. Federal grant-in-aid spending is down, defense spending will not continue its somewhat meteoric rise, oil and gas prices will not return to their pre-1981 levels for some time (if at all), and U.S. export markets for traditional natural resource products are shrinking while U.S. imports of ag and other products are increasing.

## OPTIONS

The forces that drove the rapid growth in western states' economies have reversed. What can western state political leaders and businessmen do to encourage "economic development", build the necessary infrastructure to compete in world markets, and take advantage of the existing comparative advantages the region enjoys?

Many states have traditionally focused their economic development strategies on enticing firms from outside the area to relocate. Empirical evidence has shown, however, that relocation plays a relatively small role in the new job generation process and that the trend to relocate is diminishing. The difference between growing and declining regional economies is the presence of a strong public and private infrastructure from which can come the expansion of existing firms and the birth of new ones. Comparatively speaking, expansion of existing firms is twice as important as the birth of new firms in the job generation process.

After witnessing the tremendous success of such areas as Silicon Valley in California, Route 128 in Boston, and Research Triangle Park in North Carolina, many economic development specialists began promoting "chip chasing" as the perfect way to diversify state economies. The lure of high tech as the cure to economic woes is a false one though. First, the conditions that led to the high growth in the areas just listed were the result of local factors that cannot be easily replicated — primarily the existence of first class universities which high tech firms dependent on basic research and development need. Second, most projections for job growth in the strictly high tech field are quite low through the remainder of this century with the few jobs that will be created probably being generated in existing high tech centers. Economic development efforts relating to high tech are better spent on aggressively pursuing the adoption of "high tech" production processes into existing industries in the local economy.

What then can and should state and local governments do to facilitate economic development? What follows is a list of areas that could prove beneficial for businesses and government to examine.

- Reassess state/local tax structures. While all states in the West have different tax structures, a general recommendation to reassess that structure is probably in order. Many states have historically relied on revenues from oil, gas, and coal production which have dried up in recent years. With economies moving strongly toward the trade and service sectors, combined with weaknesses in traditional industries, a shifting of relative tax burdens may be in order. States should carefully scrutinize the restructuring process so as to encourage new business. States should build capacity, not give it away. The timing for reassessment in the near future may be excellent because of the prospect of reforms in the federal tax code, to which many states' tax systems are tied, during this session of Congress.

- Encourage deregulation of intrastate commerce. Many western states have been adversely impacted by national deregulation of bus, truck, airline, and telecommunication industries. However, there is much to be gained by possible intrastate deregulation of trucking rates and trucking service to lower transportation costs for producers. Similarly, deregulation of telecommunications at the state level could encourage more competition which would stimulate more services being offered to businesses and consumers.

- Continue to improve the quality of public education. The link between education and economic development cannot be ignored. In the current school year only seven of the 16 western states have above average expenditures per pupil. At least four of those states will be hard pressed to continue that performance with falling energy prices which contributed significantly to state tax revenues. Expenditures for education will pay dividends to the state in the form of a literate, trainable, and retrainable workforce. Education must be viewed as a long term investment, one which may take 10-20 years for the benefits to become apparent.

- Encourage capital formation. The West has always been a capital poor region and market forces will continue to dictate the flow of capital into and out of the region. In addition, capital flows are now global in nature and they drive trading decisions rather than being driven by them. However, some steps can be taken to build the region's capital structure. Greater application of user fees for public works will improve access to capital through stronger bond ratings as a result of the dedicated, reliable nature of user fee revenue flows. Privatization options for delivery of public services should be examined. Streamlining regulatory processes for construction projects could decrease public costs. Interstate banking, though currently prohibited by law, is already a marketplace reality. Western states should give serious consideration to the development of regional reciprocal banking agreements in order to strengthen western banks before the inevitable competition from complete interstate banking.

- Establish a western based economic research center. A Western Governors' Association examination of the desirability of establishing a research and strategy center to help business and state and local governments anticipate and respond to changes in the national and international economy has turned up substantial support. Such a center should be established immediately to facilitate the transition of the western economy into a globally oriented, proactive economy.

Despite the current direction of economic trends, the West enjoys many comparative advantages. The region has the fourth largest economy in the world behind the rest of the U.S., the U.S.S.R., and Japan. Its pioneer heritage continues in its openness to change, strong work ethic, and entrepreneurial spirit. The natural beauty of the West will continue to support a strong tourist industry. The proximity to the Pacific Rim countries places the West in a prime position to benefit from the shift of trade towards the Pacific. The existing population is relatively young, well educated, and trainable for changing job demands. As the national population ages, many areas in the West that are desirable for retirement communities will benefit from an increased level of in-migration. The region will also benefit from the immigration of retired armed forces personnel who were trained or stationed in the West and relocate in the region after their years of service are over. In addition, the West remains the nation's storehouse of natural resources.

These advantages, if combined with actions states and local governments and business undertake in the next few years to strengthen the business climate, should ensure that the West will make the transition away from the traditional "boom-bust" economies of the past and toward a stable, growing region in the future.