Economic Development Planning, Summary 7

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Title: An Assessment of Arizona’s Economic Competitiveness: A Report from the Office of the University Economist

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Source: Center for Competitiveness and Prosperity Research, L. William Seidman Research Institute, W.P. Carey School of Business, Arizona State University

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Summary: If Arizona fails to improve its economic competitiveness, the future will be much like the past. The economy will be highly cyclical, with booms and busts, and too many workers will collect inferior wages working at jobs of subpar quality. The 2011 legislation to improve Arizona’s economic competitiveness through tax changes, incentives and other policies must be accompanied by programs to improve the
quality of education, workforce skills and infrastructure. The public sector will have to spend far more for the state to be competitive. Arizona cannot expect its climate, landscapes and low costs to continue to be enough to attract companies and workers.

**Sectors:** High-tech, construction, real estate, retail, manufacturing, mining, agriculture, health care, aerospace, biotechnology, call centers, and administrative support.

**Geographical impact:** Arizona.


**Major challenges:** Arizona’s spending on education is among the lowest in the nation, impacting the quality of the state’s workforce. The ability to attract skilled workers from other states could become more difficult if Phoenix’s quality of life becomes less attractive because of population growth and a poor quality of education. Future infrastructure needs will be substantial due to population growth and the need to replace or update aging infrastructure. Paying for infrastructure will be challenging because of tax cuts over the last two decades.

**Progress to date:** In recent years, Arizona has been among the national leaders in job creation, but the state still lags the nation in job recovery. Arizona lost about 300,000 jobs in the Great Recession and has recovered about half that many jobs. In comparison, the nation has recovered more than 75 percent of jobs lost in the recession. In late 2013, Forbes magazine and Moody’s Analytics projected that Arizona
would lead the nation in job growth over the next five years, averaging 3 percent job growth with annual economic growth of 4.6 percent.

The Arizona Commerce Authority, Greater Phoenix Economic Council and other economic development groups are pushing hard to move beyond the real estate-consumption model and further develop international markets including Mexico and the Far East, pursue innovative industries such as solar energy and strengthen such traditional industries as aerospace and defense.

For the business community, improving the level of education remains a top priority and there is hope that the implementation of Common Core Standards for K-12 will result in better-prepared graduates. In addition, the state and Science Foundation Arizona are working to produce more students with STEM (Science, Technology, Engineering and Mathematics) skills. The state’s fiscal 2014 budget includes $100 million more for K-12 education than the previous year.

There is a growing recognition of the need for more infrastructure, particularly development along the border to expedite commerce to and from Mexico and the possible construction of Interstate 11 between Phoenix and Las Vegas. A Republican governor and GOP-controlled Legislature, however, continue to monitor spending closely, keeping a tight rein on expenditures and taxes.

**Major implications:** Arizona will need to modernize its sales tax base or find other ways to raise revenues, including looking to individuals whose tax burden is very low, to help pay for public services. The state cannot expect that its climate and landscapes will be enough to continue to attract companies and workers.

**Opportunities for alignment:** The Legislature, with input from the business community, Arizona Commerce Authority and other economic development organizations, should continue to craft tax policies, programs and incentives designed to make Arizona more attractive to stable industries offering high-wage jobs. Arizona needs to invest smartly in education and job training-programs.
**Background:** A region must be economically competitive to become more prosperous. This competitiveness is a function of many factors, including the quality and availability of the workforce (of which education is a major determining factor), the quality and availability of infrastructure (airports, roads and utilities), and costs (labor, taxes, real estate, transportation and energy). Other factors include the availability of land and buildings, regulations and incentives. The tax burden is relatively unimportant.

**The economic cycle:** Arizona has one of the most cyclical economies in the nation. Construction and real estate account for a disproportionate share of the state’s economy, resulting in a faster rate of aggregate growth during times of national expansion, and declines that may be as much or more than the U.S. average during recessions.

Arizona’s recovery from the last recession has been slow. Though the pace of growth since 2010 has roughly matched the national average, Arizona has much further to go to return to where it was before the recession. In prior recessions, Arizona was able to bounce back faster.

**Drivers of economic growth:** Companies whose activities are variously called “export,” “tradable” or “basic” drive a region’s economy by selling the majority of their goods and services to customers outside the region. These companies, while relatively few, form a region’s economic base and are responsible for the health and growth of the regional economy.

Such activities as manufacturing, mining and agriculture sell a high percentage of products to customers outside the area. Other activities that import money into a region rather than sell to local residents include tourism and some services, such as national call centers serving an area greater than the local area.

A community cannot survive with residents simply selling goods and services to each other because inevitably local dollars leave the community to purchase goods and services available elsewhere.

Regional economic development focuses on attracting export industries, preferably those that are more stable and offer higher wages. High-tech
manufacturing, for example, offers greater pay and impact than a low-paying industry such as tourism.

**Location factors and economic development**: In the short term, state and local governments have few public policy tools with which to influence the economy. Basic economic forces are far more powerful than the public policies that state and local governments can wield. In the short term, the only way in which state or local government can have a major impact on the economy is through infrastructure building. In the longer term, the public policies that can most affect the economy are those that directly affect the factors most important to businesses.

The factors most important to a company in deciding where to locate a headquarters, manufacturing plant, or research and development facility, vary by industry and by company. The most important factors typically revolve around the quality and availability of a skilled workforce, infrastructure, costs, and educational opportunities, proximity to universities and research centers. Business taxes and incentives are not considered among the most important factors.

**Assessment of Arizona’s competitiveness**

**Workforce**: The quality of workforce is less important in an economy where there are more low-skill, low-wage jobs than in an economy built on high-skill, technological jobs. The level and quality of a region’s education are important aspects in the shaping of a workforce. Arizona compares poorly to other states when it comes to the quality of education that many students receive, particularly in rural areas and among Native Americans and Hispanics. This is partially offset by how easy it is for employers to hire skilled workers from out of state. However, having to go outside Arizona to hire adds to a company’s costs. It may become more difficult to attract skilled outsiders if the growth of Phoenix creates more urban problems that make the area less desirable.

**Physical infrastructure**: Arizona has historically struggled to keep up with population growth in building roads and other infrastructure. As this infrastructure ages, it will need to be replaced or updated. Most of that responsibility will land with the public sector, whose revenues are stretched. On the positive side, utilities, particularly electric power
generation, and Phoenix’s Sky Harbor International Airport are considered excellent attributes. Surface transportation is viewed negatively, however. Universities and community colleges are well regarded, but the state has relatively few university campuses for its population size.

Cost factors: Arizona’s labor costs are below the national average, but that is less of a selling point than it used to be because manufacturing and other industries can operate so much cheaper in such countries as China and India. In many cases, the importance of cost has declined as innovation, education and research and development have become bigger factors in determining the economic competitiveness of a region.

Taxes and incentives: The overall tax burden in Arizona ranks below the national average, though the impact varies very low on individuals and very small unincorporated businesses to high for large industrial companies with considerable personal property. These large industrial companies, which make up a large part of Arizona’s export base, help drive the economy and thus are particularly desirable. The low tax burden on small, unincorporated businesses has little positive effect on the economy because few small businesses are part of the economic base. Similarly, the low individual tax burden has little positive effect on the economy.

Nearly two decades of tax cuts on individuals and the lowering of business taxes has amounted, in nominal terms, to about $1.6 billion. The cumulative effect of these tax reductions, adjusted for inflation and population growth, total nearly $3 billion per year.

The Legislature passed business tax cuts in 2011 and 2012 that will result in significantly lower taxes, starting in fiscal 2014. Including associated measures such as tax credits, an estimated $645 million, in nominal terms, will be cut by fiscal 2019. A reduction in the corporate income tax rate is expected to cut $270 million in revenue when fully implemented in fiscal 2018. An additional $84 million will be eliminated in corporate income taxes with the phase-in of an increase in the corporate sales factor. In all, corporations – currently disproportionately taxed – will see substantial tax relief.
The 2011 legislation also replaced the Arizona Department of Commerce with the public-private Arizona Commerce Authority, which operates with a “deal-closing” fund and a credit for job creation.

The business tax reductions passed in 2011 and 2012 have the potential to impact economic development. However, they have yet to be phased in and it can take years for companies to make a decision about relocating or expanding. Any positive effect from the legislation will be in the future.

**Outlook:** Arizona’s economy is unlikely to return to its 2007 level before 2014 or 2015. The state is expected to grow faster than the national average and public revenues may be adequate for the current low levels of spending for a few years. But the inadequacies of the existing revenue system will become obvious as population and business growth place added demands on public services, the tax cuts of the last two years are phased in, and as the economy begins to invariably slow in another recession.

The impact of the tax and economic development legislation is not clear since public dollars are used to pay for infrastructure and services needed by businesses. If the public sector cannot provide the caliber of infrastructure and education that higher-paying, higher-technology businesses value, the legislation could have a net negative effect.

**Conclusion:** Without additional actions to improve Arizona’s economic competitiveness, the state’s economic future will be much like its past.

The recent tax and economic development legislation must be accompanied by programs to improve education, workforce skills and infrastructure. That will require the state to find additional revenues by modernizing its sales tax base, raising low personal taxes, or other means.