

Delivering the Next Economy: The States Step Up

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Thirty-seven new or freshly re-elected governors are now making the transition from campaigning to governing. They face a daunting task. Unemployment rates range from 13.0 percent in Michigan to 12.4 percent in California to 9.4 percent in Tennessee. The Great Recession has eliminated 8.4 million jobs nationally, and in hard hit states like Nevada, Michigan, and Ohio the jobs deficit is in the hundreds of thousands. As of September, the United States has only gained back 613,000 jobs since peak unemployment in December 2009. In the past three years, metropolitan areas like Denver, Nashville, and Cleveland have each lost between 50,000 and 70,000 jobs, or more than 5 percent of their jobs base.

Incoming governors also face budget deficits in the hundreds of millions or even billions of dollars, and they are very likely to make deeper cuts in already trimmed budgets for education, health care, and services for the vulnerable, the old, and the young. Unfunded costs for retired public sector workers and the possibility that local governments, themselves overextended and wrung out by the recession, will need rescuing heighten the prospect of greater fiscal turmoil.

Yet for all these impediments, a new wave of policy creativity may soon emerge from the states. Unlike 2009, the federal government will not provide Recovery Act funds to plump up state coffers for Medicaid, education, and infrastructure spending. In fact, given concerns over the deficit and the likelihood of a standoff between the administration and a divided Congress, Washington is unlikely to do much in the immediate term to bring relief. The states will innovate because they have to.

State innovation is part of the genius of our federalist system.¹ Health care reform was law in Massachusetts years before the recent passage of federal legislation. During the 1980s, governors from both parties experimented with welfare and healthcare reforms, paving the way for federal advances in the next decade. Throughout the 1950s, public university systems, established by states like California and North Carolina, set the stage for the federal technology investments of the 1960s and 1970s. And before he was president, New York Gov. Franklin D. Roosevelt experimented with interventions that foreshadowed the New Deal.

State efforts, spurred by Washington's stalemate, paradoxically create an opening for Washington to act creatively as a partner in advancing economic transformation. Rather than working with Congress to advance particular goals, the administration can achieve its aims in collaboration with willing governors, using tools such as formula grants, matching funds, competitive grants, and regulatory changes.

But today's new governors have to do more than pick up the baton from a hobbled Washington. To create jobs and build the next economy, states have to recognize the power of their economic engines: the metropolitan areas that house most of their people and generate an even greater portion of their GDP.² Metropolitan areas are critical for job creation, revenue generation, and economic growth. State policies have to unleash their potential with targeted investments and strategies that help metropolitan areas build on their distinct and concentrated assets.

This brief explains how the imperatives of the next economy will create a new balance of federalism in the years ahead, with a particular focus on the relationship between states

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and metropolitan areas. First, it details why states are likely to be on the front lines of laying the foundation for the next economy. Second, it describes a three-part playbook for states, noting that the most effective states will act as partners with their metros. Finally, the brief notes what the federal government must do to secure the next economy and how it can support state and metropolitan action, particularly if Congress is reluctant to act in the near term.

I. The State Role in Building the Next Economy

A growing chorus of business leaders and responsible economists have called for a rebalancing of the American economy, toward one driven by exports (to take advantage of rising global demand), powered by low carbon (to lead the clean energy revolution), fueled by innovation (to spur growth through ideas and deployment), and rich with opportunity (to reverse the troubling, decades long, rise in income inequality). An economy with these characteristics will necessarily have one additional feature: it will be led by metropolitan areas.

Despite notable achievements over the past two years, Washington has only partially paved the way for the next economy. Action on comprehensive climate change legislation (which would help catalyze markets for clean energy technologies through the de facto pricing of carbon) has stalled. Work to advance innovation, manufacturing, and immigration reform is either in its early stages or not even started. The much-needed multi-year authorization of the federal transportation law is more than a year overdue despite repeated calls from political, civic, and business leaders for a robust, performance-based system. Nor has Washington been as focused as it could have on the power of metropolitan areas, although the administration's investments in regional innovation clusters and sustainable communities are promising.

While it is possible that a few smart, focused federal policy actions, such as a National Infrastructure Bank, or a sharp, performance oriented, transportation law, or investments in advanced energy research, development, and commercialization could occur in the next few years, most of the unfinished federal business will almost certainly remain unfinished because of concerns about the size of the deficit and deep philosophical differences between the parties on the proper role of government. So the burden of jump-starting the next economy and supporting its metropolitan engines will shift to the states and metros.

States already share responsibility with Washington for many of the public-sector investments that will move the next economy forward. There is a continuum of federal and state spending and engagement on the constituent elements of the next economy, with both levels of government involved to a greater or lesser extent. For example, the federal government dominates in research funding, with federal actual outlays for R&D in FY 2007 of \$116 billion, compared to less than \$700 million spent by state agencies and another \$3 billion spent by state (and local) governments for R&D at colleges and universities.³ By contrast, for every dollar that the federal government spends on highways, the states spend about two.⁴ The federal Department of Education spent some \$68 billion in FY 2008, on both K-12 and higher education, plus another \$21 billion in tax expenditures related to education, but states spent more than \$400 billion of their own funds for the same purpose.⁵

Thus the roads, rails, and ports through which U.S.-made goods move to foreign markets, the workers who build advanced batteries, the scientists who develop new solar technologies, and the seed funds for good ideas will all rely to a large extent on state policies, systems, administrative apparatus, and investments. And so do the metros where those roads, ports, laboratories, factories, and people are located.

States not only have a major investment stake in the mechanisms of the next economy, they also have a history of taking the lead on urgent issues when Washington is frozen. To take just one of the most recent examples, in the mid-2000s, even as state officials argued that a national policy on greenhouse gas emissions was ideal, they forged ahead on their own climate policies.⁶ California limited tailpipe emissions of greenhouse gases,

and that state law not only became a model for adoption by other states, but will strongly shape national standards in the future. The state also moved aggressively in 2006 to limit greenhouse gas emissions from other sources, with a goal of reducing emissions to 1990 levels by 2020.⁷ Ten northeastern states (Connecticut, Delaware, Maine, Maryland, Massachusetts, New Hampshire, New Jersey, New York, Rhode Island, and Vermont) have created the Regional Greenhouse Gas Initiative, a regional cap-and-trade scheme that will lead to 10 percent reductions in carbon dioxide emissions from power generation in these states.⁸ Most states have climate action plans, and 24 have greenhouse gas emissions reductions targets.⁹ More might follow, given that climate legislation has once again stalled in Congress. As one lobbyist told the Financial Times late last year, “A number of states and regions are holding back to see if a federal program can be enacted... If not, you’ll begin to see more agitation at the state level—history shows that in the absence of federal action, the states are the ones who do the work.”¹⁰

Finally, judging from their campaigns, some new governors appear ready to act decisively on the economy in ways that Washington will not. The anti-government rhetoric of Tea Party candidates has obscured the emergence of a different group, a pragmatic caucus of governors from both parties who understand how to use public policies to unleash markets so that businesses, people, and communities can flourish.

In New York, Andrew Cuomo’s detailed economic plan includes a state infrastructure bank to make transformative investments that could link the state’s metropolitan centers to one another and the world. Michigan’s Rick Snyder, according to a recent profile, “vows to make sense out of the state budget, making budgeting decisions based on long-term return on investment—whether that means spending less money or more.”¹¹

In Colorado, John Hickenlooper wants public- and private-sector leaders to design “regional business plans” that could leverage the natural advantages of their metropolitan economies, be it geographic location, aerospace, energy, or agriculture. Bill Haslam of Tennessee echoes this call for metropolitan strategies, advocating regional “jobs base camps” to coordinate and fine-tune state economic and work-force development strategies to the business strengths, or clusters, of different parts of the state.

These leaders understand the need to build a different kind of U.S. economy from the rubble of this recession. As former local leaders, they comprehend the power and dynamics of metropolitan areas and their outsized contributions to state and national productivity and wealth. They understand how critical universities, both public and private, are to incubating the ideas and training the people who will power the next economy. They recognize that post-recession restructuring requires a business-friendly climate as well as smart investments in the assets that matter—like infrastructure or clean energy or education—in metropolitan communities.

These state leaders understand that the next economy will be shaped, determined, and delivered by metropolitan areas. Metros dominate U.S. trade, for example. The nation’s four largest exporting metros, New York, Los Angeles, Chicago, and Houston, are supersized performers, exporting more than \$50 billion apiece in 2008. The 10 largest metros, including Dallas, San Francisco, Boston, Philadelphia, Detroit, and Seattle, are home to only one-quarter of the U.S. population, but generated 43 percent of the exports of the top 100 metros and 28 percent of national exports in 2008. Smaller and medium-sized metros, such as Wichita and Portland (OR), are also leaders in exports.¹²

The low-carbon economy will be primarily invented, financed, produced, and delivered in the top 100 metros. Fifteen of the 21 national labs overseen by the U.S. Department of Energy are located within the top 100 metropolitan areas, making them hubs of clean energy innovation. And making our old and new homes, office, retail and commercial facilities energy efficient will primarily be a metropolitan act, given where most people live and businesses locate. A forthcoming Brookings paper will show that the top 100 metros concentrate 85 percent of the jobs in green architecture, building design, and construction. On innovation more broadly, our metropolitan areas are the nation’s knowledge and finance centers. The top 100 metros produce 78 percent of all patents and

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their universities and research centers receive 82 percent of NIH and NSF research funding. Almost all (94 percent) of the venture capital directed to financing laboratory breakthroughs and their transition to market is found in the 100 largest metros.

Metro leaders, like state leaders, are also filling policy (and private sector) gaps. Cities have been right alongside states in the effort to address climate change; more than 1000 mayors have pledged to lower greenhouse gas emissions in their cities to seven percent below 1990 levels (the Kyoto Protocol target).¹³ When the San Diego metropolitan area was wracked by Department of Defense cuts in the mid-1980s, a group of metropolitan leaders, led by San Diego State University, created Connect, a non-profit organization that links scientists and inventors at top research institutions with supports they need to create marketable products. The Metropolitan Mayors Caucus in Denver guided the creation of the FasTracks regional transit system, passing the zoning changes and the sales tax increase necessary to make the multi-jurisdictional rail line work. Examples abound of metros creating responses to other regional economic, environmental, and land use issues, often alongside states.¹⁴

Metros matter, and economic reality dictates that states must do a better job in the future than they have done in the past of supporting the places where most of their citizens live, work, learn, and create.

II. The State Agenda

The new opportunities of the next economy, coupled with the crushing fiscal imperatives of the Great Recession, demand a new approach to state spending. States simply cannot afford business-as-usual. While there are some exceptions, states generally allocate funds in a politically expedient way, sending dollars for transportation projects or innovation, for example, to all corners of the state, rather than using performance metrics and strict criteria for return on investment that would move them to target their metro economic engines.¹⁵ Nor have states focused on the distinctive assets of places. They apply the same tools, such as tax credits, R&D, training programs, and physical infrastructure in the same way in each place and expect that these inputs will yield results, but economic development and job creation depend on particular regional assets and dynamics, and on bottom-up innovation.¹⁶

Nor can states be similarly indiscriminate in their approach to cutting in response to the current fiscal crisis. Across-the-board cuts that take the same amount from each state agency will not help states prepare the ground for the next economy. As Governor-elect Rick Snyder has said, that kind of approach is “a management failure because that means you don’t know your job well enough to say, ‘This is more important than that.’”¹⁷ In the current economic climate, it is imperative that governors articulate a vision of the future of their states, grounded in the tenets of the next economy, that will guide their spending and their budget cutting decisions. They need to explain this vision to their legislative partners and to voters.

The framework below will help new state leaders sharpen their priorities and connect their policy ideas so that they can cut and invest differently. These recommendations are only a starting point: This paper is the first of a series of state policy innovation briefs. Future papers will provide detailed recommendations on how states can promote exports; support regional industry clusters; devise new approaches to infrastructure spending; promote advanced manufacturing; overhaul patchworks of local governments; connect higher education and workforce development; and repurpose urban land to spark economic revival.

To make the most of their money, their experience, and their assets, state leaders must do three things:

- 1) Invest in new ways to support the assets that drive the next economy
- 2) Cut to invest to jumpstart the transition to the next economy
- 3) Leverage investments through smart metropolitan strategies

Invest in new ways to support next economy assets

The next economy will be created through smart public and private interventions around the assets that matter: innovation, human capital, infrastructure, and quality of place. Making these investments requires significant policy reforms because current policies are out of synch with both the changing structure and metropolitan geography of the economy. States will likely need a new network of market-oriented, private-sector-leveraging, performance-driven institutions. These investments and institutions do not necessarily require new public resources, but they will demand that existing dollars be spent in a more targeted metro-aware fashion.

One new approach to investments that governors can take, without waiting for legislative approval, is to create jobs councils and jobs cabinets. The jobs council should comprise corporate, civic, university, and state and local leaders who quickly develop a vision for growth that is empirically grounded in the assets and advantages of the state. In particular jobs councils should focus on those economic clusters where the state is globally competitive, cognizant of the power and potential of the metropolitan areas that are the driving economic engines of virtually every state in the nation. Moreover, jobs councils should be future oriented and attempt to align the state's economic growth with where the economy is headed (e.g., driven by exports, powered by low-carbon energy, fueled by innovation) rather than where it has been (e.g., distorted by debt and consumption). Ideally, a jobs council should be named before a governor formally takes office, so that he or she can start a new term with at least a preliminary plan for economic growth that takes existing state spending streams and allocates them in more efficient and effective ways.¹⁸

A new jobs cabinet within state government could coordinate state actions in the service of economic recovery and renewal, delivering the vision developed by the jobs council.¹⁹ Or, new governors could realign their cabinet agencies to link up those departments that have responsibility over investments related to transportation, economic development, commerce, housing, land conservation, and other infrastructure such as water and sewer. In this way, the state can coordinate investments to maximize economic returns in the short term (such as job creation), strategically invest for the future, and increase governmental efficiency. The state benefits not only from strategic funding and alignment of programs, but also from mechanisms for state departments to collaborate and work together in pursuit of common state goals.²⁰

These realignments are important first steps in thinking differently about how to spend state dollars. Over the longer term, governors should take the lead on devising new ways to spend their existing (or, more likely, shrinking) resources for infrastructure, workforce development and higher education, innovation, and creating quality places.

Infrastructure is a good place to start, as it is a critical asset for the next economy, and an area that particularly cries out for new approaches to investment.²¹ To finance the kind of major investments necessary to support the next economy—such as high functioning global ports and gateways or new freight infrastructure—states should establish a state infrastructure bank (SIB), or enhance one if it already exists. Thirty-three states have established SIBs to finance transportation projects, generally through below-market rate revolving loans and loan guarantees. States are able to capitalize their accounts with federal transportation dollars but are then subject to federal regulations over how the funds are spent. Others, including Kansas, Ohio, Georgia, and Florida, capitalize their accounts with a variety of state funds and thus are not bound by federal oversight. Other states—such as Virginia, Texas, and New York—are also examining ways to recapitalize their SIBs with state funds.²² Once capitalized, these banks can be structured to be self-

financing over the long term.

Currently, SIBs fall short of their potential because they are simply used to pay for the projects selected from the state's wish list of transportation improvements, without filtering projects through a competitive application process. This is the wrong approach—states must use these SIBs strategically to finance those transportation projects that are critical to advancing the next economy. The projects should be evaluated according to the likely return on investment, not selected with an eye towards spreading funding evenly across the state. States could also expand their SIBs into true economic development banks to finance not just roads and rails, but also energy and water infrastructure, perhaps even school and manufacturing development. California's Infrastructure and Economic Development Bank (I-Bank) provides a compelling model.²³ After its initial capitalization from the state, the I-Bank has not needed state funds to continue operating. Its funding comes from fees, interest earnings, and loan repayments.²⁴

Cut to invest to jumpstart the transition to the next economy

At this point in the state fiscal crisis, the simple cuts and program reorganizations have already been made. Now, new or incumbent governors have to make some tough, long-delayed decisions. This includes shifting money out of legacy programs that lack accountability, metropolitan focus, or next economy orientation, and using the funds to support the assets that matter, such as education, innovation, and infrastructure. Governors may also need to turn to voters for new dedicated taxes or other new sources of state revenue, validated by voter referendums.

Some of the mechanisms for freeing up money to invest elsewhere are straightforward. A recent independent assessment of the Virginia transportation department's organizational structure, programs, and operations found over \$600 million in immediate savings due mainly to better contracting and project acceleration.²⁵ A January 2009 audit of the Idaho Transportation Department found over \$30 million in one-time savings over five years, and \$6 million annually thereafter.²⁶

States also should end wasteful tax breaks and other giveaways for business recruitment. Too often, state economic development policies have placed external business attraction deals at the center of their efforts, not realizing that such "smokestack" or headquarters chasing is typically wasteful at a time when resources are scarce. The hard fact: No more than 3 percent of annual state job gains can be attributed to business relocations nationally while more than 95 percent comes from the expansion of existing businesses (nearly 42 percent) and the birth of new establishments (roughly 56 percent).²⁷

Governors should also use the fiscal crisis to press for the consolidation of the proliferation of local government units, including school districts. These local governments often offer an array of expensive, duplicative services and are unable to take advantage of economies of scale. Shared services or consolidations, though politically difficult, offer a route to savings at the state and metropolitan level.

For example, a study of several New York school districts in the Binghamton region suggests that centralizing school district services such as transportation management, maintenance garages, bus routing and dispatching, facilities management, energy management, and core building operations and joint strategies for reducing health care and special education costs using a "federation model" could save \$12 to \$16 million a year for the 15 districts involved. If this strategy were replicated across the state of New York, taxpayers could realize \$87 to \$137 million a year in savings.²⁸ A 2006 study by Mercer Consulting found that a single health care benefits plan for Ohio school districts, while difficult to achieve, would save \$130 to \$175 million a year.²⁹

An examination of past New York State consolidations concludes that "Overall, consolidation is likely to lower the costs of two 300-pupil districts by over 20 percent, to lower the costs of two 900-pupil districts by 7 to 9 percent..." leading New York's State Commission on Local Government Efficiency and Competitiveness to project annual

savings from small school consolidation of \$158 to \$189 million.³⁰ The commission ultimately recommended giving the state school commissioner the authority to require school district consolidations and changing state aid formulas to provide strong incentives for school consolidation.³¹ Standard & Poor's study on behalf of the Pennsylvania Legislative Budget and Finance Committee identified 88 districts that had the greatest potential for cost savings from consolidations and concluded that savings could reach \$81 million.³² Maine has realized savings of \$36 million a year from its consolidation efforts.³³

Finally, state leaders should be prepared to go to voters to support bond issues or dedicated tax sources. Voters get the need for targeted investments in their future prosperity. In May 2010, Ohio's voters approved a \$700 million bond issue to preserve Third Frontier, the state's premier technology-based economic development initiative. The budget crisis had forced state leaders to borrow Third Frontier's 2012 funds to spend in 2010 and 2011. Ohioans knew that stopping Third Frontier investments would be devastating for their state.³⁴ And supporting Third Frontier will not result in a direct tax increase; the bonds will be repaid from general revenues, and the largest debt payment, \$92 million, due in 2018, will, as the Cleveland Plain Dealer reported, "consume less than one-third of one-percent of Ohio's general revenue and lottery profits that year, state projections showed."³⁵

Voters elsewhere have shown support for similar investments. Residents in metropolitan Phoenix, for example, approved a half-cent sales tax for regional transportation that is expected to generate \$11 billion. Los Angeles County voters approved a half-cent increase that is projected to raise \$40 billion in transportation improvements. Notably, that vote came in November 2008, right in the middle of the economic downturn.³⁶

Leverage investments through smart metropolitan strategies

The benefits of state investments are amplified when they are aligned with the specific advantages of particular metropolitan areas, whether that is a group of interconnected firms in a particular economic sector, or strength in fast-growing service exports, or globally powerful research institutions, or community colleges that develop customized job training. In the short term, states should concentrate on two jobs-creating metropolitan strategies—support for regional industry clusters and metropolitan exports initiatives.

Rather than poaching jobs from elsewhere, states can promote the growth of existing or emerging industries in regional industry clusters, the geographic concentrations of interconnected firms and supporting organizations.³⁷ Colorado's burgeoning clean-energy cluster, for example, comprises 1,500 companies and is a magnet for venture capital. In Michigan, the battery cluster benefits from targeted state incentives to promote related manufacturing and technology commercialization and positions the state to build up the regional battery value chain. Northeast Ohio's polymer cluster includes PolymerOhio, and special research initiatives at Case Western University, the University of Akron, and Kent State University, in addition to a community of suppliers and end users. The Puget Sound interactive media cluster supports more than 1,500 jobs, 150 companies, and more than \$4 billion in annual output. The Tennessee agricultural R&D cluster is focused on biofuels, catalyzed by Oak Ridge National Lab and the University of Tennessee, and complemented by DuPont Tate & Lyle BioProducts, DuPont Danisco Cellulosic Ethanol (DDCE), and Genera Energy.³⁸ As the breadth of cluster specializations indicates, clusters are found in both rural and urban areas, so cluster strategies can strengthen economic growth across the urban-rural continuum.

Clusters unleash powerful synergies and efficiencies among member firms that have the power to markedly boost the performance of the state economy.³⁹ They embody the fundamental dynamics of the "real economy" at a time when states need to focus on sound development strategies.

Through existing state economic development offices, university research offices, or business and/or civic partners, state executives should gather quality information about their industry clusters. Specifically, they need objective market analysis to document the

natural presence of clusters, their market strength, and whether they would benefit from a cluster-oriented development initiative. State and regional leaders should also create performance metrics to evaluate the efficacy of cluster investments, through outcomes such as jobs created, firms established or grown, investment attracted, and industry market share captured. A cluster strategy that either chases the trendy industries that everyone else pursues or spreads state funds around in an even and politically expedient way is a foolish waste of state funds.

Once the data analysis is done, state executives should, if warranted, establish a cluster initiative program that provides modest grants on a competitive basis to support cluster initiatives across various industries and regions of the state (both urban and rural) to build the capacity and efficacy of regional actors serving as cluster intermediaries. These grants could include small amounts for planning, somewhat larger amounts for technical assistance and start-up costs, or significant competitive program grants to support well-defined, collaborative, cluster-specific activities in areas like training, R&D, technology transfer and adoption, and marketing.

A second, related initiative would boost jobs by help existing industries export goods or services abroad. Exports are a critical component of economic recovery, as demand for American-made goods in emerging markets is surging while demand at home remains tepid. Over the long term, exports will be just as important given the rising middle class in developing nations, and the tendency of exporting firms to offer higher pay and benefits to workers at all skill levels. Simply put: More exports means more job opportunities in metropolitan areas. Brookings research shows that 5,800 jobs supported every \$1 billion in exports for the average metropolitan area in 2008.⁴⁰

States could couple some of the same tools used to support clusters, such as data collection, performance metrics, competitive grants, technical assistance, with business loans and capital to help metro areas develop and implement export initiatives that help small- and mid-sized firms in key clusters connect to global markets. States could also get their own house in order to align a wide array of existing state programs and trade assistance centers behind a more robust export initiative. State departments of transportation and education, for example, should note in their strategic plans how their actions will help exporters. For example, Florida has specific goals for freight and logistics to help achieve its objective of being a global hub.⁴¹

Over the long term, states could help metropolitan areas build on exports and clusters strategies and create market-driven, bottom-up regional economic growth plans, or “metropolitan business plans.” (Several incoming governors have expressed support for this idea.) Brookings has partnered with Chicago-based RW ventures to work with three regions—Seattle, Northeast Ohio, and Minneapolis-St. Paul—to develop this idea. Like private sector business plans, these plans would be developed by metropolitan leaders to assess the market position of the regional economy, propose interconnected and quantifiable goals and strategies to improve regional performance based on market opportunities, and create specific operational and financial plans to implement those strategies. Through these plans, metropolitan areas would characterize themselves as places with assets that state (and federal) policies should leverage, rather than collections of deficiencies that state and federal actors have to remedy.⁴²

For example, Northeast Ohio’s business plan (which builds on years of prior effort) focuses on transitioning “old economy” manufacturing companies and their employees into new markets such as advanced energy, flexible materials, and next-generation automobiles. The state can support this plan through better policy coordination between the Ohio Department of Development and its university system; better educational attainment and worker skills; enhanced public investments in innovation; and legislative, executive, and programmatic efforts to encourage regional planning, collaboration, and revenue sharing.⁴³

There are some common threads in the ways that states can support the range of metropolitan strategies, from business plans to exports. States can provide rich,

comparable data sets to help metropolitan areas quickly understand market strengths. They can provide small investments in regional capacity, such as cluster grants. Perhaps most critically, states can break out of agency silos that no longer match economic or geographic imperatives and create cross-agency teams that focus on delivering what regions say they need to succeed. None of these efforts are especially expensive: Most of them aim to use existing resources in a more targeted and efficient way.

III. The Federal Role

As noted earlier, the current political climate in Washington makes major reforms difficult.⁴⁴ Yet these tasks, some bold and sweeping, some targeted and incremental, the federal government can and must undertake to help states and metropolitan areas rebalance America's economy.

One bold move would be to modernize the U.S. tax code in support of the next economy. Our current tax system fuels the old economy's bad habits of consumption, exemplified by the huge tax subsidies we provide for consuming more and more expensive housing. The amount the government forgoes from the mortgage interest deduction is projected to grow from \$79 billion in FY 2009 to \$150 billion in FY2015. Congress and the president need to alter the deduction so that it costs Treasury less. If the program was retooled such that it continued to cost \$79 billion over each of the next five years, half of the savings could go to lowering the federal deficit. (The mortgage interest deduction may be losing its status as politically untouchable: The co-chairs of the National Commission on Fiscal Responsibility and Reform have raised the idea of eliminating the mortgage interest deduction entirely, capping it at 80-85 percent of current levels, or excluding second homes, home equity loans, and mortgages over \$500,000.⁴⁵)

The remainder of the savings, some \$25 billion a year, could be invested in ways that advance the next economy. For example, a more robust R&D tax credit could spark innovation. A national infrastructure bank, which, like the state banks proposed above, would finance the complicated multi-modal and multi-jurisdictional infrastructure projects needed to speed the path of American goods to foreign markets and to reduce carbon emissions throughout our transportation system.⁴⁶ Energy discovery institutes would develop and, critically, move to commercialization new low-carbon energy technologies.⁴⁷ Tax reform is a critical cut-to-invest move at the federal level.

The federal government also needs to reform and invest in transportation. Under a deficit-neutral approach, the existing transportation law should be reauthorized (not simply extended), for two full years at its current funding level, to provide stability for transportation planning—including hiring workers. But even though the level of funds should remain the same, there must be reforms in how those funds are spent. These reforms include: federal performance measures in safety and system-wide asset management; a new partnership with metro areas that raise their own revenue that reduces bureaucracy and accelerates project delivery; better coordination of existing federal credit assistance programs such as TIFIA; and a permanent authorization of the so-called TIGER grants to encourage state and metropolitan innovation.⁴⁸ These critical reforms set the stage for a truly transformative six-year bill in 2013.

Second, the federal government could work with states to overhaul the performance of key programs that deliver the assets of the next economy. The Race to the Top competitive grant program is a clear example of how a comparatively tiny amount of federal spending can reinvent how states deliver education. Tennessee, New York, Florida, and Ohio won Race to the Top grants in the range of \$400 million to \$700 million. In exchange for these funds, states were required to raise the caps on charter schools; use one of four prescribed strategies to improve the performance of low-achieving schools; and develop promotion standards for teachers based on student achievement.⁴⁹ All of these are significant and controversial undertakings, made in pursuit of grants that are just a fraction of these state's overall education budgets, which range from \$3.8 billion to \$19.9 billion.⁵⁰

Or, Washington could reprise a familiar bargain with states: More flexibility to experiment,

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using federal dollars in different ways, in exchange for stricter accountability standards. The Obama administration has made laudable efforts in creating more integrative policy approaches at the federal level, as evidenced by new collaborations between HUD, DOT, and EPA. States (and metros) should enjoy the same flexibility in trying to align conflicting federal programs and rules.

Finally, the federal government could join states in supporting bottom-up metropolitan efforts to deliver jobs and rebuild their economies with strategic and flexible responses. So, the federal government could build on nascent efforts across several federal agencies (DOE, DOL, SBA, USDA, among others) to advance regional industry clusters through better data gathering, information sharing, and mechanisms for states and metro areas to coordinate cluster efforts.⁵¹ It could align the International Trade Administration, the SBA, the Ex-Im Bank, and the Department of Transportation to guide and support metropolitan export initiatives, even to the point of inventing a prototype that a specific metropolitan area could test. Federal support of metropolitan business plans would include better interagency coordination, cross-agency teams focused on regions, and better information.

The federal government's support of the Los Angeles region's 30/10 plan is a potential model for the kinds of federal help that metros need, and that Washington should provide, now. The region hoped to deliver 30 years' worth of approved, tax-funded transit projects over 10 years to speed up much-needed job creation and economic development. Los Angeles Mayor Antonio Villaraigosa asked the federal government for an innovative financing package to kick-start the project, including a low-interest loan that will be paid back with the proceeds of the voter-approved sales tax. Late last month, the federal government approved a \$546 million loan, leveraged by a \$20 million federal grant.⁵² This is not about massive new programs or old-fashioned earmarks, but about arranging very small sums (at least at the scale of the federal budget) to help metropolitan areas do what they know they must do to reorient their economies.

IV. Conclusion

In our federalist system, all levels of government are responsible for supporting the next economy, and each level interacts with, influences, and learns from the others. In the short term, though, states will move to the forefront in developing policies that support the next economy and metropolitan economic engines because they can, and they must. The demands of a global marketplace, the need to find new sources of jobs, and the imperative to replace the broken economy will not recede just because the president and Congress disagree on how to move forward, or are preoccupied (with good reason) with the federal deficit.

But as states take the lead, with some strategic assists from the federal government, they need to recognize that they are partners with their metropolitan areas, and to welcome the force of metropolitan innovation and economic might. States are responsible for creating a framework of laws, regulations, and targeted assistance in which their economic engines can flourish. As metropolitan areas continue to innovate, states have to enable and support that innovation, and encourage their metros to imitate and improve on what is happening elsewhere.

The next decade will be one of the most disruptive in American history, given broader trends of global restructuring, demographic transformation, low carbon imperatives, and technological possibilities. For political, fiscal, and structural reasons, neither metros, nor states, nor Washington can rise to the complexities of the moment by themselves. But for these same political, fiscal, and structural reasons, the states are best positioned to take the lead in bringing the nation into the next economy.

Endnotes

1. "It is one of the happy incidents of the federal system that a single courageous State may, if its citizens choose, serve as a laboratory; and try novel social and economic experiments without risk to the rest of the country." *New State Ice Co. v. Liebmann*, 285 US 262 (1932), (Brandeis, J., dissenting).
2. In 47 states, the majority of state GDP is generated by metropolitan areas, including such supposedly rural states as Kansas, Nebraska, and Iowa.
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4. Robert Puentes, "A Bridge to Somewhere: Rethinking American Transportation for the 21st Century," p. 39 (Washington: Brookings Institution, 2008).
5. For federal education spending, FY 2008, see U.S. Department of Education Budget Summary FY 2009, Archived Document, p. 100, available at <http://www2.ed.gov/about/overview/budget/budget09/summary/09summary.pdf>. Tax expenditures related to education are found in U.S. Office of Management and Budget, "Analytical Perspectives, Budget of United States Government, Fiscal Year 2009," p. 290, available at <http://www.gpoaccess.gov/usbudget/fy09/pdf/spec.pdf>. For state education spending, FY 2008, see National Association of State Budget Officers, "FY 2008 State Expenditure Report," p. 13, 21, available at <http://www.nasbo.org/Publications/StateExpenditureReport/tabid/79/Default.aspx>. The NASBO numbers do not appear to take state tax expenditures, such as tax-advantaged 529 plans, into account. Even including the massive infusion of ARRA funds in 2009 does not erase the overall state dominance in education spending. ARRA education funds amounted to about \$98 billion dollars, and were a one-time, exceptional infusion. A perhaps better comparison of education spending post-recession is the federal budget request for the Department of Education in FY 2011: At \$77 billion, it is still just a fraction of what states spend. State and federal education spending is especially disproportionate at the K-12 level, where, in FY 2008 states account for about 43 percent of total funds for k-12 education, local governments about 38 percent, and the federal government about 9 percent. See also U.S. Department of Education, "Overview: the Federal Role in Education," at <http://www2.ed.gov/about/overview/fed/role.html>
6. See, for example, Commonwealth of Massachusetts et al v. U.S. EPA et al, Brief for the Petitioners, available at <http://www.abanet.org/publiced/preview/briefs/pdfs/06-07/05-1120petitioners.pdf>, in which twelve states, including California and a number of states in the Regional Greenhouse Gas Initiative, argued that the U.S. EPA must regulate greenhouse gas emissions.
7. California Assembly Bill 32 (2006), available at <http://www.arb.ca.gov/cc/docs/ab32text.pdf>
8. See www.rggi.org
9. See the Pew Climate Center's maps of state climate change policies at http://www.pewclimate.org/what_s_being_done_in_the_states/state_action_maps.cfm
10. Hal Weitzman, "Mandatory scheme makes modest gains in northeast" *The Financial Times*, December 13, 2009.
11. Melissa Maynard, "Moderate Republican candidate swims against party tide in Michigan," *Stateline.org*, October 4, 2010, available at <http://www.stateline.org/live/details/story?contentId=517938>.
12. Emilia Istrate, Jonathan Rothwell, and Bruce Katz, "Export Nation," (Washington: Brookings Institution, 2010).
13. The Mayor's Climate Protection Agreement was created by former Seattle Mayor Greg Nickels. More information on the agreement, including links to a list of signatories and the text of the agreement, is at <http://www.usmayors.org/climateprotection/revised/>.
14. Mark Muro and others, "MetroPolicy: Shaping a New Federal Partnership for a Metropolitan Nation" (Washington: Brookings Institution, 2008), pages 36-37.

15. Exceptions, to name just two examples, are Ohio's Hubs of Innovation program and Pennsylvania's Community Action Teams
16. See Gregory Tasse, *The Technology Imperative*. (Cheltenham, UK: Edward Elgar, 2007) and Gregory Tasse, "Rationales and Mechanisms for Revitalizing U.S. Manufacturing R&D Strategies," *Journal of Technology Transfer* 35 (3): 283–333.
17. Maynard, October 4, 2010
18. Virginia represents one model for emulation. In 2002, Gov. Mark Warner created an Economic Development Strategic Planning Council to create a four year economic development strategy. Warner's Council developed the "One Virginia-One Future" plan, which helped drive major efforts throughout his tenure, including efforts to strengthen public education, enhance the affordability of community colleges, improve worker training, expand access to broadband technology, and boost exports.
19. Tennessee's Gov. Phil Bredesen established a Jobs Cabinet by executive order upon assuming office in 2003. The executive order designates the commissioner of the Department of Economic and Community Development chair of the Jobs Cabinet. The cabinet includes commissioners from seven state departments as well as representatives from higher education (e.g., the president of the University of Tennessee) and business (e.g., the president of the Tennessee Chamber of Commerce and Industry). Governor Bill Ritter established the Colorado Jobs Cabinet in 2008 and, earlier this year Governor Deval Patrick created the Massachusetts Advanced Manufacturing Initiative.
20. For example, in California the secretary of the agency for Business, Transportation, and Housing coordinates and oversees 14 departments and several economic development programs and commissions. By executive order, Connecticut's Governor Jodi Rell established the Office of Responsible Growth in 2006 to link up policy development and capital planning in the areas of economic and community development, environmental protection, agriculture, and transportation. (Connecticut Executive Order 16, October 2006) Michigan, for example, has a Department of Energy, Labor & Economic Growth that brings together job, workforce, and economic development functions under a single agency. That office could be expanded to include transportation and environment and to centralize the economic development planning that is now carried out by the state's 14 regional agencies. New York also has a multiplicity of these agencies and has made some attempts at coordination through entities such as the Economic Recovery and Reinvestment and Smart Growth Cabinets, but there is room for deeper synchronization of these efforts.
21. For more details on the state infrastructure bank and other state infrastructure reforms, see Robert Puentes, "State Transportation Reform to Deliver the Next Economy," forthcoming, Brookings Institution.
22. Virginia has proposed capitalizing its SIB with the proceeds from privatizing the state-run liquor stores. Comments of Matt Strader, Virginia Assistant Secretary for Transportation, "Obama's Infrastructure Agenda: Understanding The Pillars," Brookings Institution, Washington, D.C. September 16, 2010.
23. Stanton C. Hazelroth, Testimony before the House Ways and Means Committee Subcommittee on Select Revenue Measures, May 13, 2010. http://waysandmeans.house.gov/media/pdf/111/2010May13_Hazelroth_Testimony.pdf.
24. Ibid.
25. Cherry, Bekaert & Holland, L.L.P., "Performance Audit of Significant Operations of the Virginia Department of Transportation," August 2010.
26. Office of Performance Evaluations, "Idaho Transportation Department Performance Audit," Idaho Legislature, Report 09-03, 2009.
27. Jed Kolko, "Business Relocation and Homegrown Jobs," (Sacramento: Public Policy Institute of California, September 2010).
28. New York State Commission on Local Government Efficiency and Competitiveness, "Savings Estimates" (2008) available at http://www.nyslocalgov.org/pdf/Savings_Estimates.pdf.
29. Mercer Health and Benefit, "A Spectrum of Opportunities: The Report to the School Employees Health Care Board" (Schools Employees Health Care Board, 2006) available at <http://sehcb.ohio.gov/Portals/0/pdf/Third%20Party%20Documents/MercerFinalReport12-20-06.pdf>

30. New York State Commission on Local Government Efficiency and Competitiveness, "Savings Estimates" p.2.
31. New York State Commission on Local Government Efficiency and Competitiveness, "Comprehensive List of Recommendations" (2008), available at http://www.nyslocalgov.org/pdf/Comprehensive_List_of_Recommendations.pdf.
32. Standard and Poor's School Evaluation Services, "Study of the Cost-Effectiveness of Consolidating Pennsylvania School Districts, Part 1 of 2, Statewide Analysis" Prepared for the Pennsylvania Legislative Budget and Finance Committee (2007), available at <http://lbfc.legis.state.pa.us/reports/2007/289.pdf>
33. "School Administrative Organization," available at <http://www.maine.gov/education/reorg/index.html>.
34. As an independent review of Third Frontier, by SRI International, found, "The experience of other states and clusters, such as Silicon Valley, Research Triangle Park, or Austin, is that it takes 20 to 30 years for regions to achieve the critical mass that becomes self-sustaining... Many [similar] efforts have failed due to lack of long-term support and innovation," SRI International, "Making an Impact" (p. 99).
35. Tom Breckenridge, "As May 4 Election Nears, Debate over Ohio's Third Frontier Program Heats Up," *Cleveland Plain Dealer*, April 11, 2010, available at http://www.cleveland.com/business/index.ssf/2010/04/as_may_4_election_nears_debate.html
36. Mark Muro and Robert Puentes, "Helping Those Who Help Themselves," *The New Republic*, *The Avenue* blog, May 27, 2010 <http://www.tnr.com/blog/the-avenue/75191/helping-those-who-help-themselves>.
37. Mark Muro and Kenan Fikri, "Leveraging Regional Innovation Clusters to Reignite Innovation, Entrepreneurship, and Job Creation," forthcoming, Brookings Institution.
38. Mark Muro and Bruce Katz, "The New 'Cluster Moment': How Regional Innovation Clusters Can Foster the Next Economy," p. 17 (Washington: Brookings Institution, 2010).
39. Ibid.
40. Istrate, Rothwell, and Katz.
41. Enterprise Florida, *Florida Roadmap for Economic Development: 2010-2015 Roadmap* (Enterprise Florida, 2010). Available at <http://www.eflorida.com/IntelligenceCenter/Reports/Roadmap/GlobalHub.pdf>
42. Robert Weissbourd and Mark Muro, "Metropolitan Business Plans: A New Approach to Economic Growth," (Forthcoming March 2011).
43. Ibid. See also Fund for our Economic Future, Manufacturing Advocacy and Growth Network and others, "Northeast Ohio Metropolitan Business Plan" (Forthcoming March 2011).
44. See, for example, Jackie Calmes, "Deficit Divisions Likely to Grow After Election," *The New York Times*, October 25, 2010.
45. Erskine Bowles and Alan Simpson, co-chairs' proposal, November 10, 2010, available at http://www.fiscalcommission.gov/sites/fiscalcommission.gov/files/documents/CoChair_Draft.pdf. Both Option 1 and Option 2 of their tax proposals suggest alterations in the mortgage interest deduction.
46. The administration's 2010 budget and a recent House bill propose capitalizing the national infrastructure bank at \$25 billion over five years. Of course, the federal government could, and should, include the National Infrastructure Bank in comprehensive transportation legislation.
47. Funding would eventually rise to \$5 billion annually, or \$50-300 million per institute per year, augmented by state, university, and private sector investments. These institutes would consist of regional consortia of technology firms, private research centers, governments and universities, which would compete for federal funding and themselves be the anchors for regional industry clusters around clean energy. James Duderstadt and others, "Energy Discovery Innovation Institutes: A Step Toward America's Energy Sustainability" (Washington, Brookings Institution, 2009). See also Steven Hayward, Mark Muro and others, "Post-Partisan Power," available at <http://thebreakthrough.org/blog/Post-Partisan%20Power.pdf>.
48. The Transportation Infrastructure Finance and Innovation Act (TIFIA) provides loans and loan guarantees to qualified projects. The Transportation Investments Generating Economic Recovery

(TIGER) program challenged states and metropolitan areas to devise their own solutions to their particular transportation challenges. TIGER is competitive program where projects are selected based on their merits through integrated approaches across modes (highway, transit, rail) and policy areas (infrastructure, housing, land use). TIGER proved to be wildly popular and the initial round of \$1.5 billion available for grants received 38 times that much in applications.

49. U.S. Department of Education, "Race to the Top Program Executive Summary," November 2009, available at <http://www2.ed.gov/programs/racetothetop/executive-summary.pdf>.
50. See, for example, Grover J. "Russ" Whitehurst, "Did Congress Authorize Race to the Top?," Education Week, April 27, 2010, also available at http://www.brookings.edu/opinions/2010/0427_education_whitehurst.aspx.
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