TD Economics

The Transformation Imperative:
Bringing Business Dynamism to the U.S. Capital Region

Shernette Mcleod, Economist | 416-415-0413

November 7, 2019

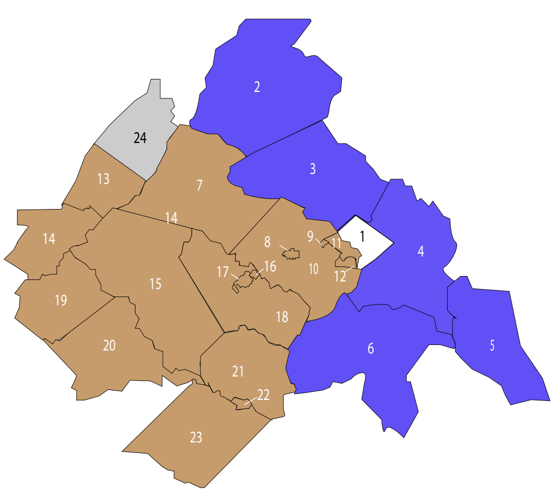
Highlights

- While not the only story, the upswing in federal spending over the past few years has been a key catalyst for growth in the national capital region. Looking ahead, the two-year bipartisan budget deal passed in Congress last summer bodes well for continued solid expansion over the near term.
- However, the picture for the region's economy over the longer haul becomes murkier. With the federal government running unsustainable deficits, the region remains deeply exposed to a sudden shift in the pendulum to fiscal restraint.
- The good news is that policymakers within the region have recognized this risk and are seeking to diversify the regional economic base by encouraging growth in more non-federally dependent businesses. There have already been some successes, such as landing the second corporate headquarters for online retail giant Amazon. This thrust needs to be maintained and intensified as the region seeks to build greater resilience into its economic future.

In recent years, the economy of the U.S. capital region has been doing well. Growth in GDP, wages, personal income and employment is up, and the unemployment rate is at a cycle low. While certainly not the whole story, federal spending in recent years has been among one of the key growth catalysts, delivering substantial net economic benefits across the area. In fact, as the epicenter of federal government, the national capital region has always enjoyed certain economic advantages, including relative insulation from the severe negative effects of broader economic downturns.

The near-term outlook for the capital region remains bright, especially in light of the two-year bipartisan budget deal passed this past summer. The budget deal not only increases spending on an array of programs, but reduces the risk of another government shutdown through fiscal 2021. However, over the longer term, the picture becomes considerably muddier. With the federal government running unsustainable deficits, the region remains deeply exposed to a sudden shift in the pendulum back to fiscal restraint. Past episodes of restraint and/or temporary shutdowns show how reductions in federal spending can have a negative effect on the region's economic prospects.

Chart 1: Washington-Arlington-Alexandria, DC-VA-MD-WV Metropolitan Statistical Area



The good news is that policymakers in the region have been working to diversify the economy away from this over-reliance on federal spending. In particular, there have been efforts across the region to draw more investment to non-federally dependent private businesses, though with varying degree of success. Examples of this include DC's thriving tech scene, Maryland's thrust to rebrand itself as a destination "Open for

Business" and more recently, Virginia's coup to bring online retail giant Amazon to the state. The region has many positive qualities that are attractive to businesses, including a highly educated workforce, quality infrastructure and a high-quality transportation network. The drive to diversify the private sector base of the economy needs to be an ongoing, deliberate strategic plan, as the region seeks to wean off its traditional dependence on federal spending.

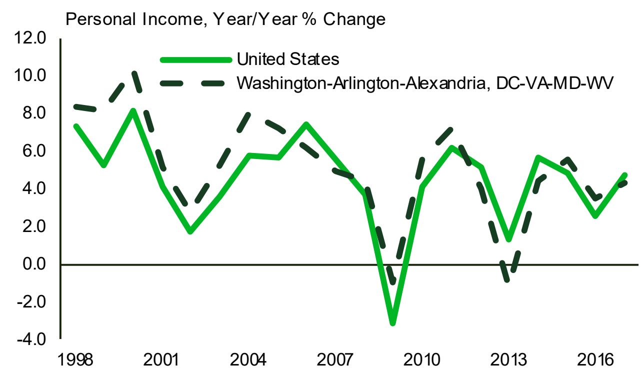
Snapshot of the National Capital Region

The Washington-Arlington-Alexandria, DC-VA-MD-WV Metropolitan Statistical Area (often abbreviated to just the Washington D.C. MSA) is the metro area centered on the nation's capital. It includes D.C., five counties in Maryland, 17 counties and independent cities in Virginia, and Jefferson County in West Virginia, for a total of 24 jurisdictions (Chart 1). Of note, two counties excluded from this Census Bureau official definition, Howard County and Anne Arundel County, are often considered as a part of the economic area. This is so since they account for a fair share of Maryland's cybersecurity activity, with economic impacts that spill over into the Washington D.C. metro area.

Despite rising levels of net domestic out migration, the metro's population of 6.25 million (2018 estimates) makes it the 6th largest MSA in the country, largely due to an influx of international migrants. The metro is one of the most educated and most affluent metropolitan areas in the U.S., boasting a median household income of just under $100,000 in 2017 (see Table 1). Aside from direct federal government, key industries in the region also include scientific research, defense contracting and tourism.

Notwithstanding a few bumps along the way, the capital region is coming off roughly four years of robust economic growth. Unemployment in the region is at a cycle low of 3.2% (vs. national at 3.7%), which has supported income growth and kept it roughly running in line with the national rate (Chart 2). Employment growth has also been solid averaging 1.6% over the last four years, driven primarily by expansion in the professional and business services, education and healthcare and leisure and hospitality sectors.

Chart 2: Regional Income Growth in-line with National



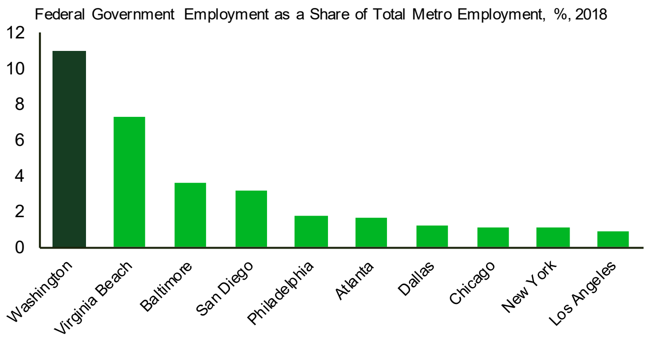
Source: BEA, TD Economics

Federal Government is Important, but poses Risks

No matter how you slice it, the federal footprint looms large in the region. The direct federal share of employment has been edging down, as other areas — notably within the private sector — have increased their relative weighting. In fact, the professional and business services industry has emerged as the region's single largest employer, at 23% of total jobs (though some of these are due to federal contractors). Nevertheless, the federal sector still directly accounts for a notable 11% of employment in the Washington D.C. metro area

Table 1: Washington D.C. MSA at a Glance	
Population:	6,249,950, ranked 6th of the 15 largest employment metros (2018)
Unemployment Rate:	3.2%, ranked 3rd lowest rate among the 15 largest employment metros (Aug. 2019)
Households:	2,203,717, ranked 7th of the 15 largest employment metros (2017)
Median Household Income:	$99,669, ranked 2nd of the 15 largest employment metros (2017)
GDP:	$530 billion, ranked 5th of all metros (2017, current dollars)
Payroll Jobs:	3,303,025, ranked 5th of the largest employment metros (2018)
Professional & Business Service Jobs:	761,425, ranked 4th of the 15 largest employment metros (2018)
Federal Government Jobs:	363,991, ranked 1st of the 15 largest employment metros (2018)
Total Federal Spending:	$114.9 billion (2018)
Federal Procurement Spending:	$82.3 billion (2018)
Source: BEA, BLS, Census Bureau, Spending.gov, TD Economics	

Chart 3: Relative to Peers, Federal Government Employment Plays a Larger Role in the Washington DC Metro



Note: Graph shows data for the metros with the highest level of federal government employment. Names of MSAs have been abbreviated. Source: BLS, TD Economics

– landing it the top spot among metros with a significant federal presence (Chart 3).

To put this in perspective, in California and Texas, which have the highest absolute number of federal workers, direct federal employment only accounts for 1.4% and 1.6% of total state employment, respectively.

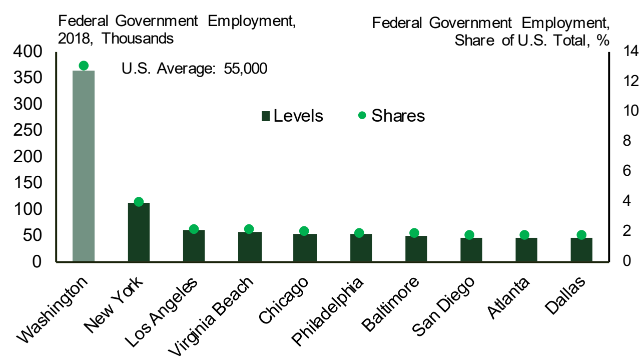
However, the direct share grossly understates the true contribution of federal spending to the region's economy, since many businesses across the goods and services sectors derive a substantial percentage of their business from government contracts. There are notable multiplier effects associated with federal government employment. Some estimates suggest that the federal government accounts for up to 52% of jobs in the Washington D.C. metropolitan area.[1] The outsized share of government employment becomes evident when compared to other metros that also boast a relatively high government presence. Approximately 13% of all federal jobs in the United States are located in this metro, more than three times the share of the next highest metro which stands at 3.9% (Chart 4).

Federal procurement also carries great heft in the capital. Federal spending on goods and services was over $512 billion in 2018, and on average the Washington D.C. metro accounted for over 16% of that total federal procurement spending (Chart 5).

Given these outsized shares, it is not surprising that the significant loosening in the federal government purse strings in recent years has pulled the economy along for the ride. Overall federal spending has grown at a healthy annual average clip of just over 4%. Furthermore, the Congressional Budget Office projects that outlays will continue to expand at roughly a 5% pace over the next two years in line with the levels set in the recent budget deal.

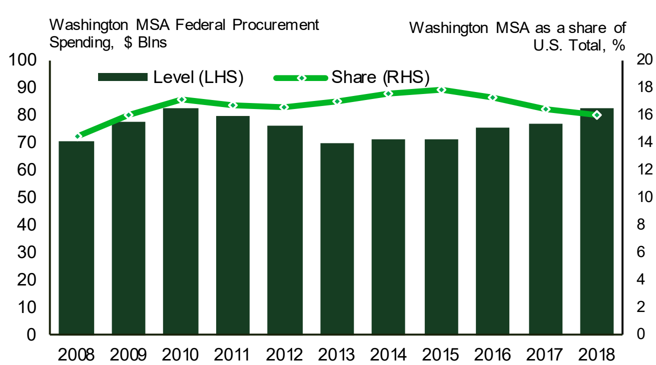
But while this spending will continue to deliver net benefits to the region over the near term, questions loom over the longer-term outlook. The combination of higher spending and lower revenues in the wake of the 2017 Tax Cuts and Jobs Act have left a growing hole in the federal fiscal position. Total public debt currently stands at over $22 trillion, or approximately 104% of GDP. The portion that is held by the public (as opposed to intragovernmental holdings) now exceeds $16.5 trillion (79% of GDP) (Chart 6). The Congressional Budget Office (CBO) estimates that this debt held by the public could hit $29.3 trillion by 2029, representing approximately 95% of GDP – the highest level since just after World War II.

Chart 4: Federal Government Employment Concentrated in the Capital Region



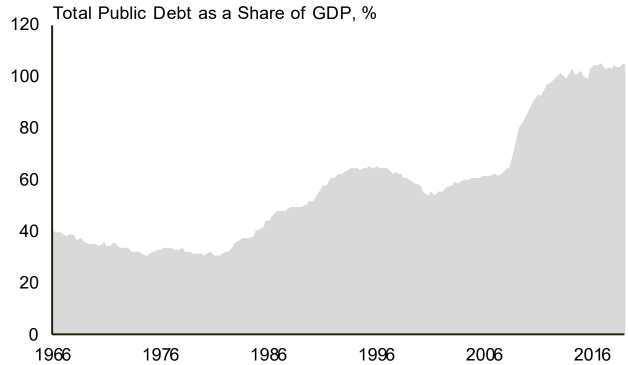
Note: Names of MSAs have been abbreviated. Source: BLS, TD Economics

Chart 5: Contractors in the Capital Region are Heavily Dependent on Federal Procurement Spending



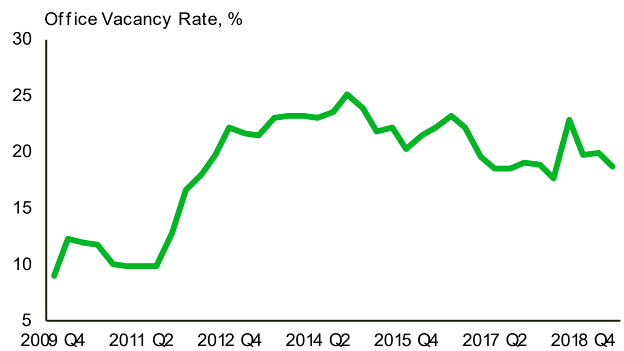
Source: USASpending.gov, TD Economics

Chart 6: U.S. National Debt Hits the Highest Level in History



Source: U.S. Office of Management and Budget, TD Economics. Last data point 2019

Chart 7: Office Vacancy Rate in Crystal City, Virginia Rises in Response to Clousure of Federal Offices



Source: CoStar, TD Economics . Last data point 2019Q2

At some point, the U.S. government will have to address its structural deficit. This will almost certainly include federal spending cuts. Three recent examples provide a cautionary tale on how shifts in government policy can negatively impact the capital region's prospects.

First, Northern Virginia was one of the most severely affected areas from the Base Realignment and Closure (BRAC) initiative undertaken from 2005 to 2011, which resulted in the closure, consolidation and relocation of numerous federal government offices in the region. The Crystal City neighborhood of Arlington in particular, suffered from the streamlining of federal and defense spending, which lead to the closure of several government offices and military bases in the area. These closures are estimated to have cost Crystal City over 13,000 jobs and over 4.2 million sq. ft. of office space was vacated. The city still has not fully recovered from this event, with the most tangible reminder evident in the commercial real estate market. Here, office vacancy rates have persistently remained elevated at around 20% since then (Chart 7). Redevelopment of the area has only recently been kickstarted with the rebranding of the neighborhood (along with two adjoining others) as National Landing, the new home of the Amazon HQ2 project.

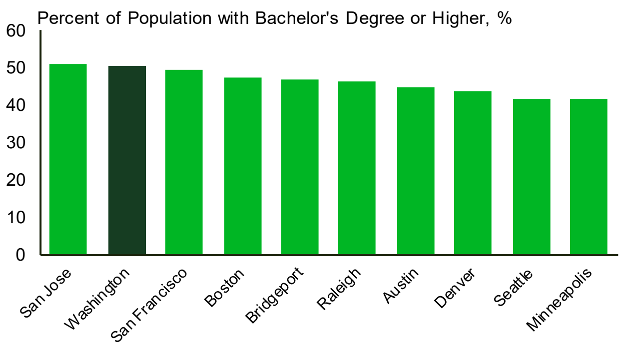
More recently, the region also experienced an economic contraction in 2013 resulting from the passage of the 2011 Budget Control Act (BCA). This Act mandated a reduction in federal spending over the 2012 – 2021 period and resulted in automatic spending cuts – the Sequester – if Congressional agreement was not achieved. Ultimately, this reduction in spending has been sidestepped by four subsequent Bipartisan Budget Acts, which allowed discretionary spending to exceed the caps set by the BCA, including the deal reached this past August. However, just the possibility of Sequester cuts has increased uncertainty and likely held back investment to some extent.

Lastly, the region's vulnerability to the actions of the federal government was highlighted last winter by the longest government shutdown on record. Both federal employees and contractors went without wages for over a month between December 2018 and January 2019, and while federal workers received back pay, many contractors did not. The fallout from the shutdown included a decline in revenues for many local businesses that were not recouped. The states themselves also saw a decline in both income and sales tax collection. Finance officials in Maryland for example, estimated that the state lost $2.1 million in sales tax revenue halfway through the shutdown. While temporary, the effects of the shutdown were certainly disruptive and illustrate how a more permanent and sizeable reduction in federal spending could disrupt economic activity in the region.

The Capital Advantage

These past experiences and potential future headwinds point to the need for greater business dynamism to cultivate economic resilience in the national capital region. The region does possess competitive advantages that can be leveraged to diversify the economy. For starters, it has one of the most highly educated workforces in the nation (Chart 8). Approximately 51% of the regional labor force has a college degree or higher, relative to the national average of 32% (about half the region's adults hold bach-

Chart 8: The National Capital Region has One of the Most Highly Educated Populations in the Nation



Note: Among metros with populations greater then 500,000. Names of MSAs have been abbreviated. Source: US Census Bureau ACS, TD Economics

elor's degrees, and nearly a quarter have graduate degrees). The region has a great deal of international connectivity, with several international organizations (such as the IMF, World Bank, United Nations, embassies and consulates to name a few) boasting a presence there. There is also a high concentration of government and business leaders. Of course, being the seat of the federal government cannot be ignored as this too may be leveraged to create a multifaceted and thriving local economy and business sector. The D.C. regional area is a place where industry, policy and a skilled workforce all intersect.

Infrastructure and public transportation are also well-developed, enhancing both the ease of commuting within the region and quality of life. In fact, two projects are currently underway to further enhance the public transportation network – 1) extension of the metro's Silver Line and 2) creation of a Purple Line light rail transit. These planned expansions would serve to further improve the region's desirability for business investment since they increase connectivity.

These attributes are attractive to many industries and provide a solid base for private businesses to grow independently of federal spending. The access to policymakers and thought leaders only possible in the nation's capital can also be leveraged to the region's advantage, without engendering overdependence. The idea is to position the region to withstand future shocks, while capitalizing from the advantages it currently possesses. Some early signs of diversification in all three sub-states are already starting to appear.

Maryland has launched a "Maryland Marketing Partnership", to tout Maryland as a hub of innovation and ideal place to locate or grow a business. Among other things, the Partnership aims to attract businesses to Maryland, encourage local businesses to grow and change perceptions of the Maryland business climate. It was created in 2015 to develop a branding strategy for the state, market the state's assets and encourage the location and growth of new businesses. In 2017, the organization launched a new "Open for Business" marketing campaign, which placed ads both within Maryland and outside the state in key markets and industries targeted for business development such as cybersecurity, life sciences, financial services, and advanced manufacturing – areas in which the state already has significant clusters. The impact thus far has been limited but the intent is to focus on bringing more non-federally dependent businesses to the state. This is an ongoing process that will undoubtedly take some time.

In the District (DC), there is a well-developed tech sector. DC is home to several large tech companies such as Blackboard, CoStar, and Vox Media. It also features a thriving startup ecosystem with numerous co-working spaces, accelerators, and incubators spread throughout the city. This network provides the support needed to develop the District as a thriving technology and entrepreneurship center. Washington D.C. has also sought to leverage the ease of access to key decision makers and supervisory bodies, to market itself as a prime location for companies in federally regulated industries. It's extensive network of higher educational institutions, finance ecosystem and array of research institutions, makes the District a global hub for innovation in technology, policy, finance and many other disciplines, offering even greater opportunities for further diversification away from direct federal spending.

Virginia has also embraced diversification, ramping up its attempts to draw in businesses from a diverse set of private sector enterprises ranging from IT to manufacturing to supply chain management. In response to damage caused by previous defense department cutbacks, the Commonwealth has sought to encourage startups by establishing cybersecurity accelerators (such as Mach37), which help startups raise capital, find talent and develop business skills.[2] They have also enlisted their University network to collaborate with entrepreneurs, developing IT products with applications in areas such as health care. Added to this, the state has positioned itself to become the premier data center hub in the country, capitalizing on an industry in which it has significant comparative advantage. They have also launched a business-led GO Virginia economic growth and diversification plan, which seeks to support programs that create more high paying jobs through collaboration among local government, industry and academia, with the aim of diversifying and strengthening the economy.

Putting these Advantages to Work: The Case of Amazon's HQ2

Amazon's decision to locate its second headquarter (HQ2) in Northern Virginia is a high-profile example of the attractiveness of the capital region. The arrival of HQ2 is expected to breathe new life into Arlington County and Virginia, and to deliver a jolt to overall regional economic activity. It represents a key piece of the regional economic transformation which began over a decade ago. Amazon's value to Virginia isn't just about Amazon itself, but rather about the multiplier effect it can have to trigger even greater changes to the region's economic base and solidify the structural transformation.

Amazon's search for a second corporate headquarter location invited cities to outline assets such as workforce skills, community livability, educational facilities, transit and infrastructure quality. In its proposal to attract Amazon, Virginia (as well as Maryland and D.C., as places in all three jurisdictions initially made the shortlist) highlighted all these attributes and was eventually able to land what has been touted as the economic development deal of the century.

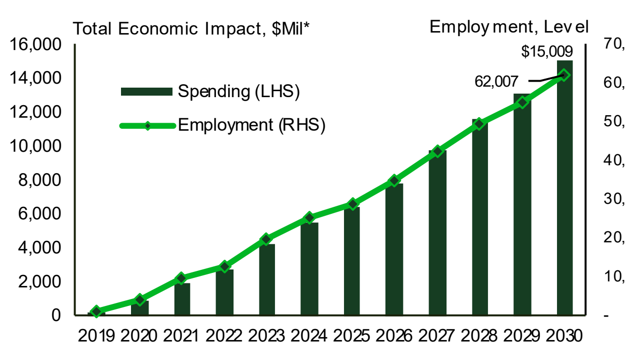
The impact of Amazon's HQ2 should not be underestimated. It will have economic, fiscal and housing impacts on Arlington County, the Commonwealth of Virginia and the Greater Washington region. Its reach will even extend to the higher educational sphere as two universities will be developing innovation campuses and tech-related curriculum to help spur technology education, training and entrepreneurship. This is likely to have an ongoing impact on the regional tech-related labor market.

Further, Amazon has the capacity to generate jobs across the entire skill spectrum in excess of those directly tied to HQ2 (estimates suggest employment multipliers in the range of 2-5), improve commercial vacancy rates, and help diversify the economy. Given the dynamic linkages which already exist within the region, this effect is expected to radiate throughout the region, continuing to strengthen ties.

Over the project implementation period (2019 through 2030), Amazon is projected to invest an estimated $1.8 billion (in nominal dollars) in the development of HQ2. This is inclusive of construction costs, purchases of furniture and fixtures, equipment and design fees. They also plan to increase their workforce from an initial 400 employees in 2019 to 25,000 by 2030. A study commissioned by the Virginia Chamber of Commerce suggests that, combining capital expenditures and ongoing operation of the HQ2 could result in a total economic impact (direct, indirect and induced) for Virginia of over $14 billion in 2030 when the headquarters is fully implemented, which would support almost 60,000 jobs.[3] Projections for the Washington D.C. MSA, which includes D.C. and suburban Maryland, are also close to these estimates with a total economic impact of $15 billion in 2030 and over 62,000 jobs (Chart 9). An alternative measure suggests that for every 1000 Amazon employees, the associated total economic impact for the region can reach up to $575 million, with the capacity to support over 2500 regional jobs.

These effects could boost employment growth in Northern Virginia from 1.2% to 1.3% over the ensuing period, and in Arlington county from 1.2% to 2.2%. State tax revenue collection (primarily composed of income and sales taxes) is also projected to total $1.83 billion cumulatively over the 2019 to 2030 period, with collection of almost $347 million in 2030 alone. These benefits should help to diversify the regional tax base and lessen dependence on the federal sector.

Chart 9: Amazon HQ2's Impact on the Washington DC Metro Area is Projected to be Significant



*Total Economic Impact consists of Capital & Operational Spending
Source: Chmura Economics via Virginia Chamber of Commerce, TD Economics

Not all Smooth Sailing

Despite some successes, the ongoing process to diversify the economic base of the region has not been without its pitfalls. The region still needs to focus on creating a regulatory environment that is growth enhancing. For example, this regulatory challenge was highlighted in a recent report by the D.C. Policy Center, which revealed that 37% of D.C. businesses found unpredictability of business conditions, due to changing government rules and regulations, to be a problem.[4] An additional 36% of respondents complained that the District's tax burden was consistently higher than surrounding jurisdictions, while others emphasized the challenge of obtaining permits and other certifications from the city.

The educational and training infrastructure within the region must also continue to better align their curriculum to the demands of the modern workplace by creating courses that rely on input from the region's employment leaders. The District (D.C.) also recently pulled some tax incentives that were offered to the tech sector. While not yet evident, this could have some effect on sector development in the future. As the fallout from the recent government shutdown has shown, overall the region still has some way to go to wean its dependence on the federal pocketbook.

Bottom Line

The capital region is currently enjoying a period of robust economic activity. A key feature underpinning this has been the presence of the federal government. While the region has benefitted enormously from its proximity to the federal sector, it has also experienced notable hardships from disruptions to federal government operations. The rising national debt load is likely to lead to greater fiscal restraint down the road, which means spending cuts and possibly employment cuts. Any such retrenchment of federal spending is likely to have a notable effect on the economies in the capital region.

The states in the capital region have started a process of transformation to help build an economic base that is independent of federal operations. The region has many attractive features for various industries, and Amazon's recent decision to locate a headquarters there is a key success. Diversifying the region's economy is key if the states wish to mitigate the disruption that can be caused by future political decisions in Washington.

As things stand, the economic outlook for the region remains solid, supported by business investment, including Amazon's HQ2, and healthy job creation (see latest state economic forecast here). As such, 2019 GDP growth of 1.8%, 1.7% and 2.7% is expected for D.C., Maryland and Virginia respectively, with growth of about 2% for the metro area.

Endnotes

1. https://www.economicmodeling.com/2013/11/01/how-many-jobs-does-the-federal-government-explain-in-the-washington-d-c-metro/
2. http://www.virginiabusiness.com/news/article/diversifying-the-economy
3. "Economic Impact of Amazon's Major Corporate Headquarters in Virginia and the Washington MSA" Chmura Economics and Analysis for the Virginia Chamber of Commerce, Dec 2018
4. D.C. remains a strong jobs center, but business leaders warn that companies are still fleeing at an alarming rate. https://www.bizjournals.com/washington/news/2019/10/04/d-c-remains-a-strong-jobs-center-but-business.html