

THE STATE OF THE STATE ECONOMY

ECONOMIC CURRENTS



Diverging Destinies: The Commonwealth's Relatively Robust but Imbalanced Economic Recovery

THE STATE'S OVERALL ECONOMIC RECOVERY MASKS WIDENING INEQUALITY IN EDUCATION, INNOVATION, AND INCOMES, AS WELL AS GROWING REGIONAL IMBALANCES.

MICHAEL GOODMAN AND ROBERT NAKOSTEEN

A Robust Recovery . . . for Some

In many respects, the Massachusetts economy appears to be moving in the right direction. In the first quarter of 2011, the MassBenchmarks Current Economic Index estimated that gross state product expanded at an annual rate of 4.2 percent, over twice that of the nation during the same period. In recent quarters the Commonwealth has settled into a pattern of growth consistent with, and at times faster than, national economic growth.

For well over a year the state economy has been on the mend, and this appears to be continuing. The state labor market, which lost nearly 143,000 jobs from its prerecession peak in March 2008, has regained over 85,000 of those jobs since its low point in August 2009. While the national labor market weakened notably in May and June, the state’s unemployment rate, which peaked at 8.8% late in 2009 fell to 7.6% in July of 2011.

However, particularly noteworthy about this recovery is that the state has exceeded and nation has nearly recovered its prerecession level of real gross product (the dollar value of all goods and services produced, adjusted for inflation). And yet, the nation is producing this product with an employment level that has dropped by nearly 7 million since the onset of the recession, while the state is achieving its output with almost 60,000 fewer workers.

This phenomenon highlights some important aspects of the nature of the recession as well as the recovery that we are now experiencing. The trigger for the recession was the financial crisis that followed a precipitous fall in asset prices, house prices foremost. This event led to serious

balance sheet problems for both business and households; experience with balance sheet recessions is that they last longer and recover more slowly (once recovery begins) than recessions brought about by other factors.¹

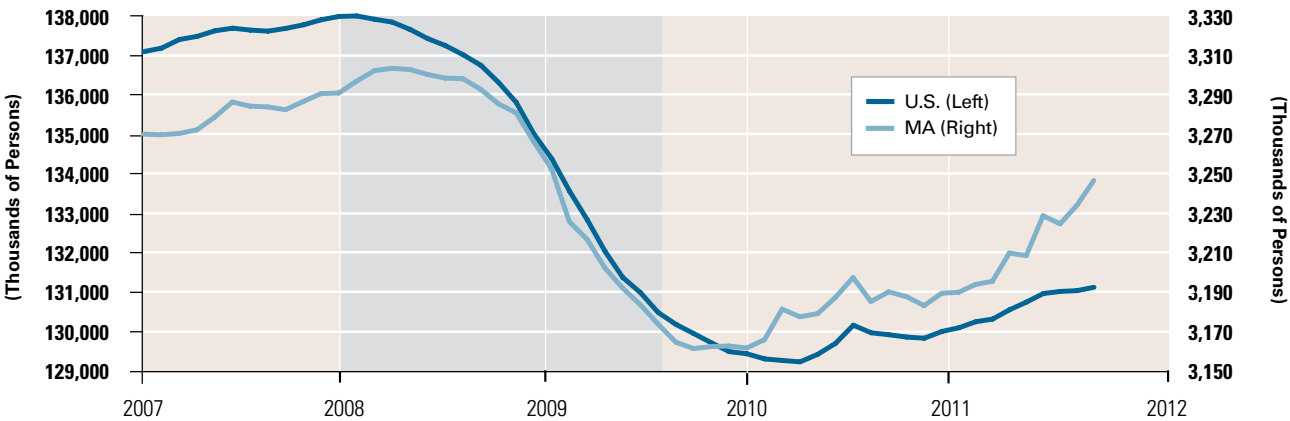
Productivity and its Discontents

The recovery to date has been characterized by consumers who are reluctant to spend and businesses that are reluctant to hire, factors that have conspired to reduce household consumption and economic activity in a number of key sectors. Consequently, in consumer-sensitive sectors it has largely been a relatively jobless recovery. Even as business prospects improve, albeit at a measured pace, many employers have been able to squeeze additional output from a static employee base. Their continued ability to do so has allowed for steady economic expansion without comparable growth in employment.

While much of the growth in productivity can be attributed to the growing importance of the state’s high productivity industries as growth drivers, many workers have not yet seen the benefits of this growth, a phenomenon referred to by some analysts as the compensation-productivity gap.² Nationally, the labor share of income — the share of output received by workers as compensation — which had averaged 64.3 percent between 1947 and 2000, fell to a historical low of 57.8 percent in the third quarter of 2010.³

In an environment of relatively slow job and very little wage growth, it is not surprising that a statewide public opinion poll⁴ conducted earlier this year found that nearly

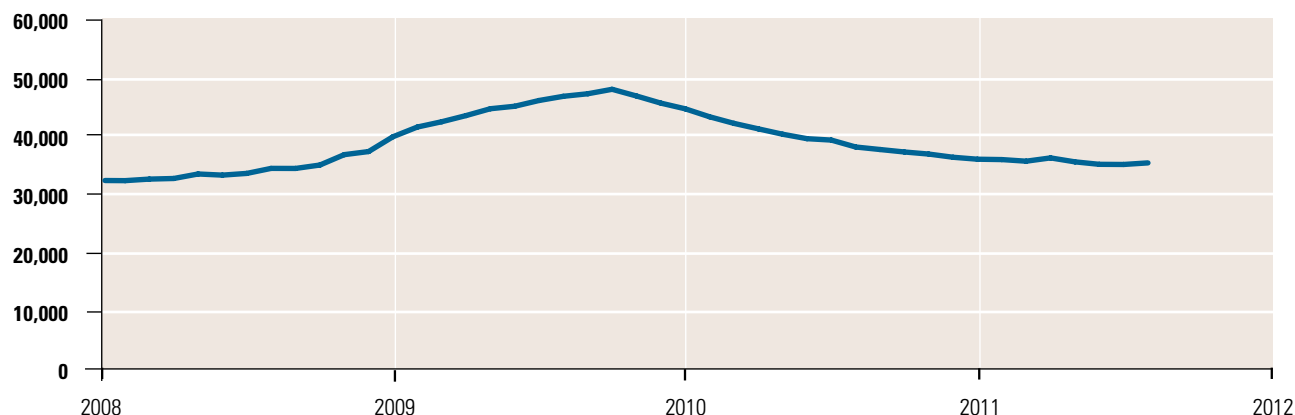
Figure 1. Massachusetts has experienced a more rapid recovery in total employment than the U.S.
Total Nonfarm Employment, Seasonally Adjusted



Note: Shaded areas indicate U.S. recessions
Sources: U.S. Bureau of Labor Statistics, Establishment Survey data, seasonally adjusted; National Bureau of Economic Research

Figure 2. Massachusetts monthly initial claims for unemployment benefits have been on a downward trend

Initial Claims in Massachusetts, Not Seasonally Adjusted, Moving Annual Average



Sources: U.S. Bureau of Labor Statistics; calculations by authors

one in three Massachusetts households (31.6 percent) were worried that they or a member of their household could lose their job in the next three months. Nearly two-thirds of Bay State households reported being very concerned about jobs (65.0 percent). This level of anxiety in the face of what in aggregate terms has been a relatively robust recovery is particularly striking.

This anxiety is not entirely misplaced. While monthly initial claims for unemployment have declined to a level that makes it appear as if the worst of the private sector layoffs are behind us, the lack of demand for workers in a number of key industries appears to be weighing heavily on the willingness of workers to demand wage increases or seek alternative employment opportunities as would be normally expected given the pace of the current economic expansion and slow wage growth.

The Innovation and Education Divide

The Bay State's knowledge-intensive industries have been the recipients of substantial investment and the beneficiaries of growing demand for their productivity-enhancing products and services. This has been largely responsible for the Commonwealth's growth premium of late. Note that this is very much a national phenomenon and that in many respects the ability of the Massachusetts economy to outperform the United States in employment and output growth is the result of its leadership in the global innovation economy. The firms and workers most directly benefitting from this growth are largely in eastern Massachusetts, primarily in the Greater Boston region. Job opportunities in these industries typically require a post-

secondary education, particularly for those occupations that pay wages required for a middle class standard of living in the state's higher cost of living areas where many of these firms and job opportunities are located.

Although not new, this pattern of development has become more pronounced in the current economic recovery in part as a result of the growing importance of the innovation economy as a growth driver. A parallel development has been the continuing struggle of many of the industries that have traditionally provided quality job opportunities to the less well-educated members of the labor force.

For many years, the rapidly growing sectors of the state economy have rewarded their employees with high incomes, including in some cases generous bonuses. These sectors include financial services, information technology and software development, health care, professional and business services, and private education.

In contrast, industries that have traditionally offered more blue-collar paths to middle-class prosperity, such as traditional manufacturing and construction, continue to struggle and, despite some signs of life in recent months, remain well below their prerecession employment levels. Ongoing fiscal pressures are expected to lead to further layoffs in state and local government. Expected layoffs of teachers, police officers, firefighters and other municipal workers will put further pressure on working families that rely on these jobs for their livelihoods and that have neither the skills nor the physical proximity to the sectors that have been growing and where economic opportunity exists.

Not surprisingly, workers with higher levels of educational attainment are faring much better than their less well-educated counterparts and communities with a high

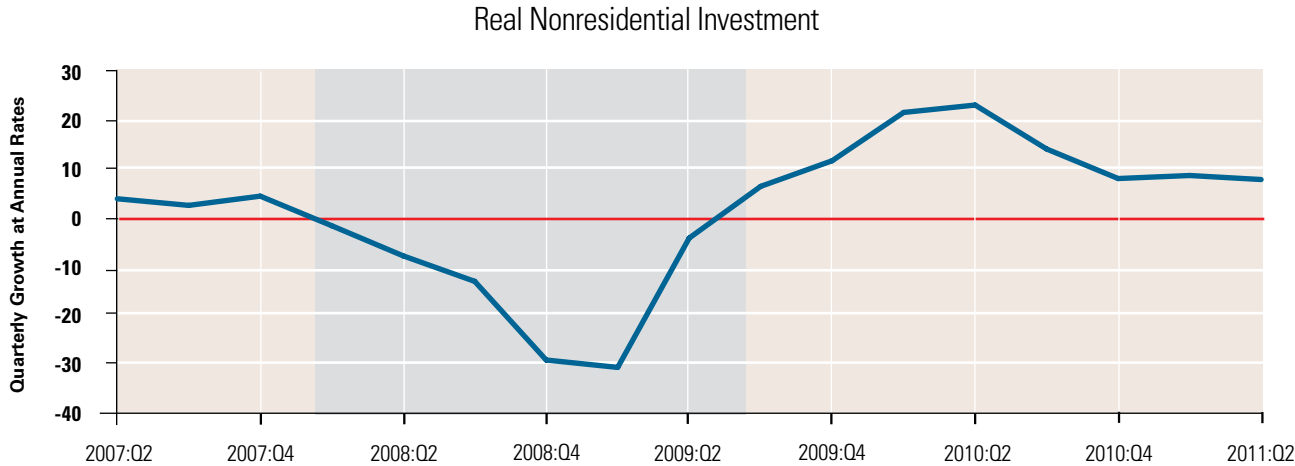
share of well-educated residents have been sharing in this success. As can be seen in Figure 5, much of urban Massachusetts continues to struggle economically as reflected in their higher, in some cases much higher, unemployment rates, especially in communities with low educational attainment. Without the presence of growing employment sectors and with their traditional sources of employment continuing to struggle, these cities face profound economic development and educational challenges.

The destinies of the Commonwealth’s regions and communities are diverging rapidly and this growing inequality appears to have been reinforced and accelerated by the current economic recovery. Many of the state’s

communities, including but not limited to its Gateway Cities, face the dual challenge of having no substantial connection to the Massachusetts innovation economy. They lack a workforce with the necessary education and skills to successfully compete in an economy where job opportunities in construction, traditional manufacturing, and state and local government are scarce.

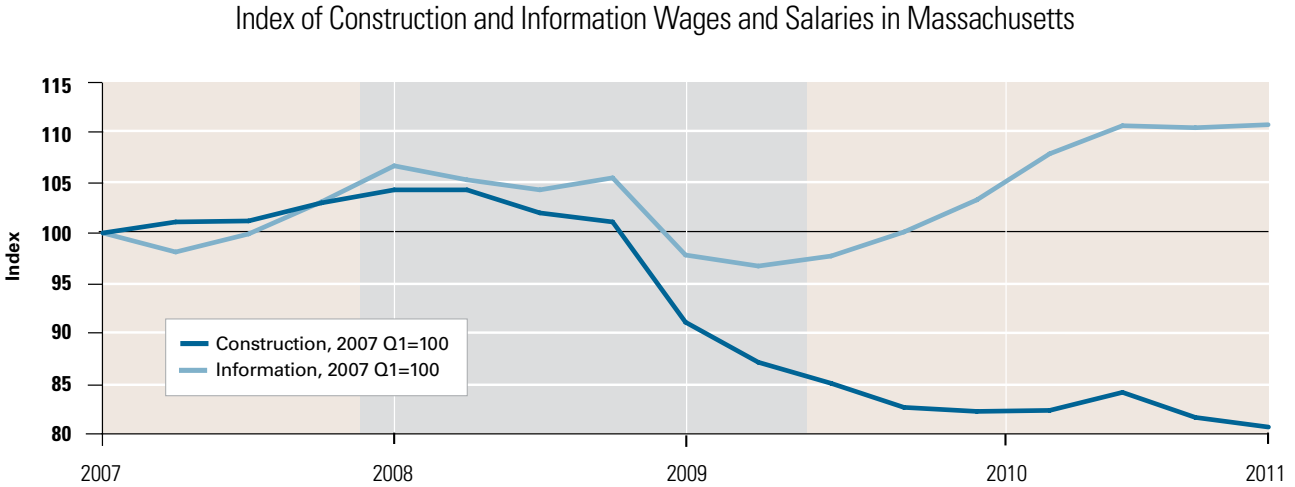
The patterns of economic development during the current economic recovery help to highlight what has been a longer-term trend of increasing inequality in Massachusetts. These divergent destinies of the Commonwealth’s people, regions, and industries can be clearly seen in the changing distribution of family income in Massachusetts.

Figure 3. Investment in equipment and software continues to grow at double-digit rates



Source: U.S. Bureau of Economic Analysis

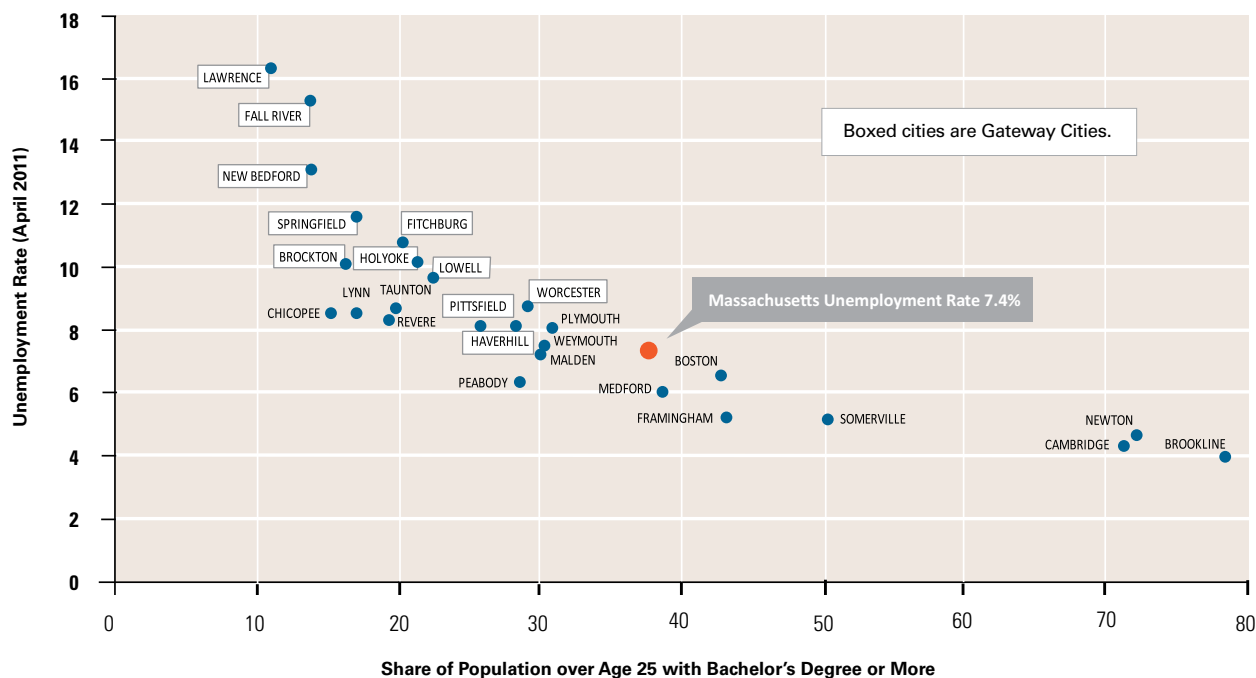
Figure 4. A Tale of Two Sectors



Note: Shaded areas indicate U.S. recessions

Source: U.S. Bureau of Labor Statistics, Establishment Survey data, not seasonally adjusted

Figure 5. The Education Gap: Major Massachusetts Cities



Note: This figure shows the top twenty-five largest cities (in total population) according to both Decennial Census 2010 and AFF ACS 2005-2009 plus three additional Gateway Cities
Sources: U.S. Census Bureau, American Community Survey 2005-2009 and Decennial Census 2010; Massachusetts Division of Unemployment Assistance, LAUS series; calculations by UMass Donahue Institute

Income Inequality in Massachusetts, 1979-2008

Widening income inequality is a national phenomenon and the experience of Massachusetts looks very similar to that of the U.S. according to a recent Census Bureau analysis.⁶ According to the Census Bureau, in 2009, the Gini coefficient for Massachusetts — a measure of the inequality of a distribution where zero represents perfect equality and 100 represents perfect inequality — was 46.8, statistically indistinguishable from the U.S., which had a Gini coefficient of 46.9⁷ during the same period.

The pattern of changing income distribution in Massachusetts since 1980 can be seen in Figure 6, which divides families into quintiles based upon their income. The median family income is used to describe the income of the 20 percent of Bay State families in each quintile. All data are in 2009 dollars.

The pattern that emerges had been identified previously⁸ but has become more pronounced in recent years. Between 1979 and 1999, all quintiles experienced real growth in family median income. However, this growth was not equally distributed, as the top income group

enjoyed considerably stronger income growth, closely followed by those families in the next highest income quintile. Income growth for the bottom 40 percent of Massachusetts families was significantly slower, leading to greater inequality over time. However, while income growth was not equal during this period, all five quintiles experienced real income growth during the 1980s and 1990s.

Between 1999 and 2008, income growth slowed notably even for the highest-income families. Income growth in the first eight years of the new century was slow but positive for higher income families but at the lower end of the income scale, the picture was far different. In real terms, incomes fell between 1999 and 2008 for families earning the 2008 state median of \$81,258 or less.

Growing inequality in family incomes in Massachusetts is further illustrated by the growing ratio of median incomes of the top 20 percent of families and their neighbors in the bottom fifth of the family income distribution. As can be seen in Figure 7, in 1979 the median income of the highest quintile of families was just over 6 times that of the lowest. Between 1980 and 2008, this ratio grew by over 40 percent to nearly 8.6 to 1.

Rising inequality has been a fact of life in all regions of the Commonwealth since 1980. However, the steepest rise in inequality has been in the Greater Boston region, where

in 2008 the median family income in the top fifth of families was ten times that of their counterparts in the bottom fifth.

Strikingly, in the Pioneer Valley and Berkshire regions, in real terms the median income of families in the lowest income quintile is now well below 1979 levels — falling from just above \$20,000 in each region in 1979 to just below \$16,000 in 2008 (or 24 and 29 percent respectively). In stark contrast, the median family income in the highest income quintile in Greater Boston grew from \$150,295 in 1979 to \$232,879 in 2008, a real increase of 55 percent. While the experience of Greater Boston and the two Western Massachusetts regions stand out, the pattern of rising real incomes in the top quintile and flat or declining incomes in the bottom quintile is evident in each of the seven principal economic regions of the Commonwealth.

Rising income inequality across Massachusetts reflects a divergence of the destinies of many Bay State families, communities, and regions. While this pattern is by no means new,

it is clear that recent events have served to exacerbate the inequality that has become a disturbing fact of life in the contemporary Massachusetts economy.

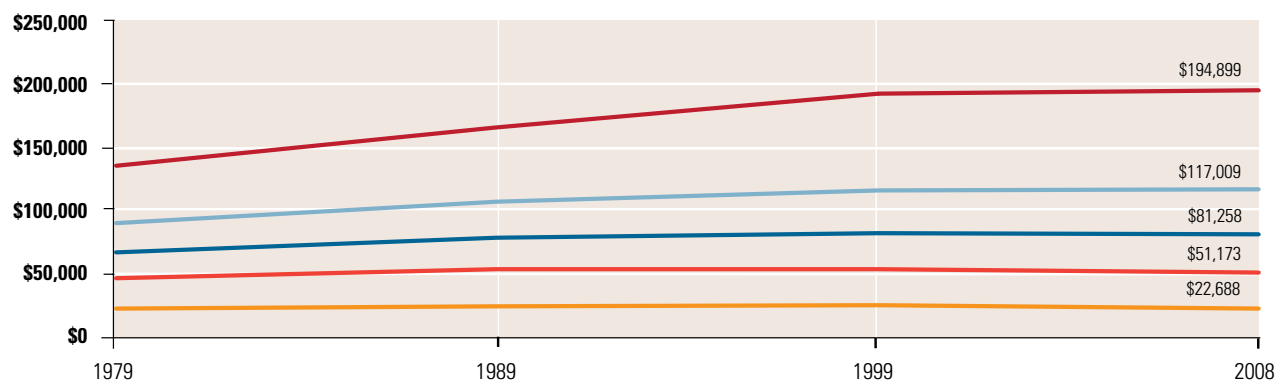
Continued Housing Market Woes Weigh on the Recovery

While the Massachusetts economy is showing no signs of slowing, a number of risk factors weigh heavily on the sustainability of the Commonwealth’s economic recovery. A major concern continues to be the condition of the housing market.

Housing Prices are continuing to decline

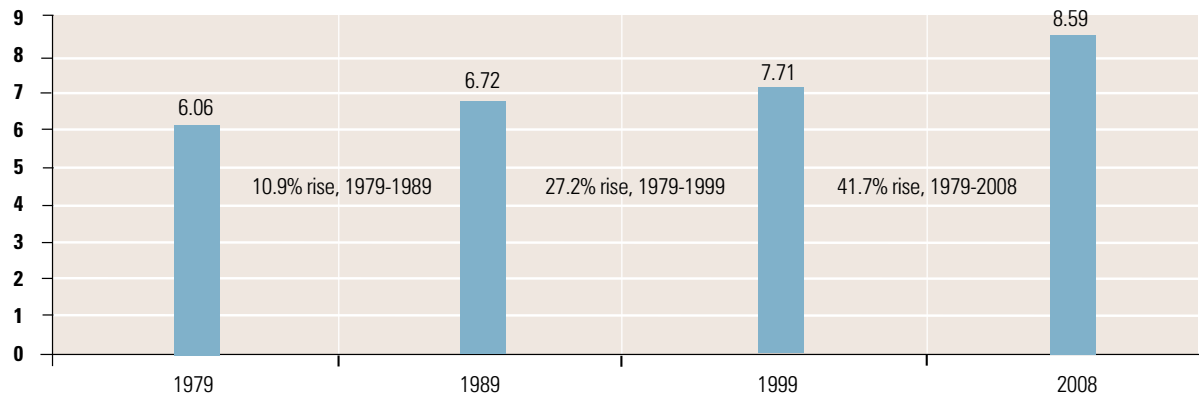
The housing slump in Massachusetts is now in its sixth year. According to the latest S&P Case-Shiller Home

Figure 6. Massachusetts Median Family Income by Quintile



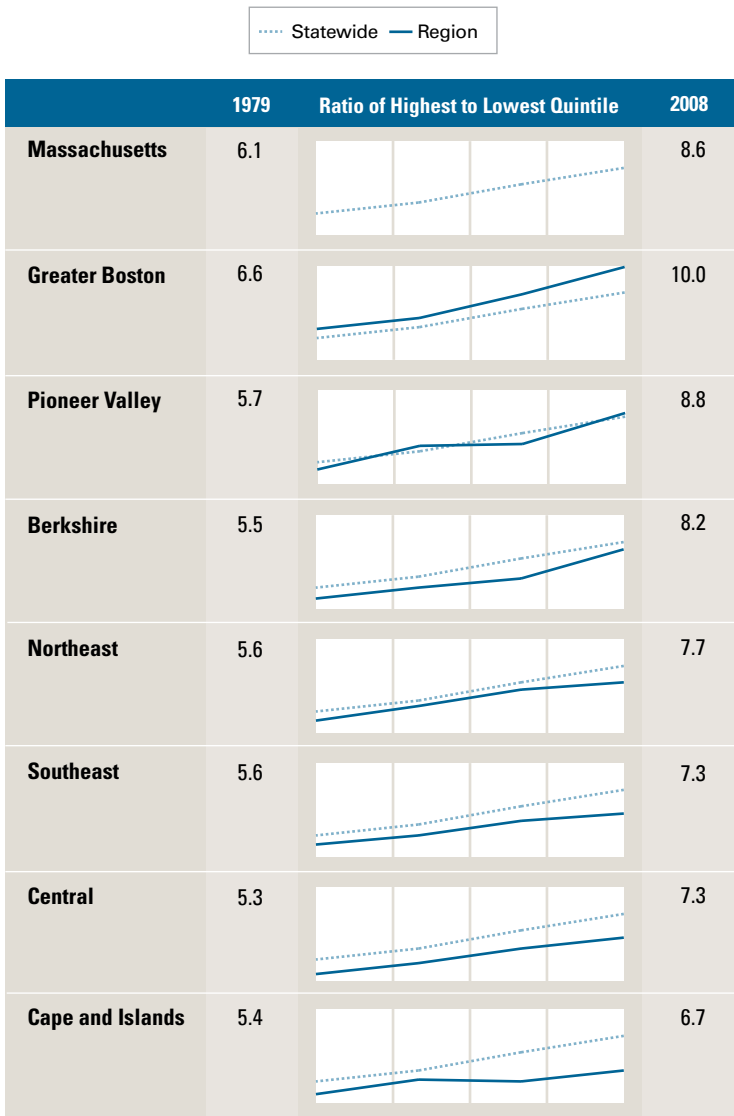
Note: Adjusted to 2009 dollars
Sources: U.S. Census Bureau, American Community Survey 2009 and Decennial Census 1980, 1990, 2000; calculations by UMass Donahue Institute

Figure 7. Rising Income Inequality in Massachusetts: 1979 to 2008
Ratio of Median Family Income: Highest Quintile to Lowest Quintile



Source: U.S. Census Bureau, Decennial Census and American Community Survey; calculations by UMass Donahue Institute

Figure 8. Ratio of Highest to Lowest Family Income Quintile by Region



Note: The median of each quintile is used as the basis for the calculations
Sources: U.S. Census Bureau, American Community Survey 2009 and Decennial Census 1980, 1990, 2000; calculations by UMass Donahue Institute

Price Indices (March 2011), home prices are continuing to decline both nationally and in the Metro Boston area, where home prices have fallen 16.1 percent from their peak and have now fallen back to levels last seen in February of 2003. About 15 percent of Massachusetts homeowners with mortgages are underwater, owing more on their homes than their homes are worth in today’s market.⁹

While being in a negative equity position does not mean that homeowners will default,¹⁰ it definitely makes these households more vulnerable to default in the event of a disruption of their income (job loss, divorce, death, etc.) and, in light of continuing difficulties in the labor market, is not an encouraging sign.

Price declines have not appreciably improved affordability

The pattern in price levels similarly highlights the different trajectories of the national housing market and states with the worst housing bubbles compared with Massachusetts.

As Figure 9 illustrates, absolute price levels in Massachusetts rose significantly higher during the so-called housing bubble period and have declined more slowly during the downturn.

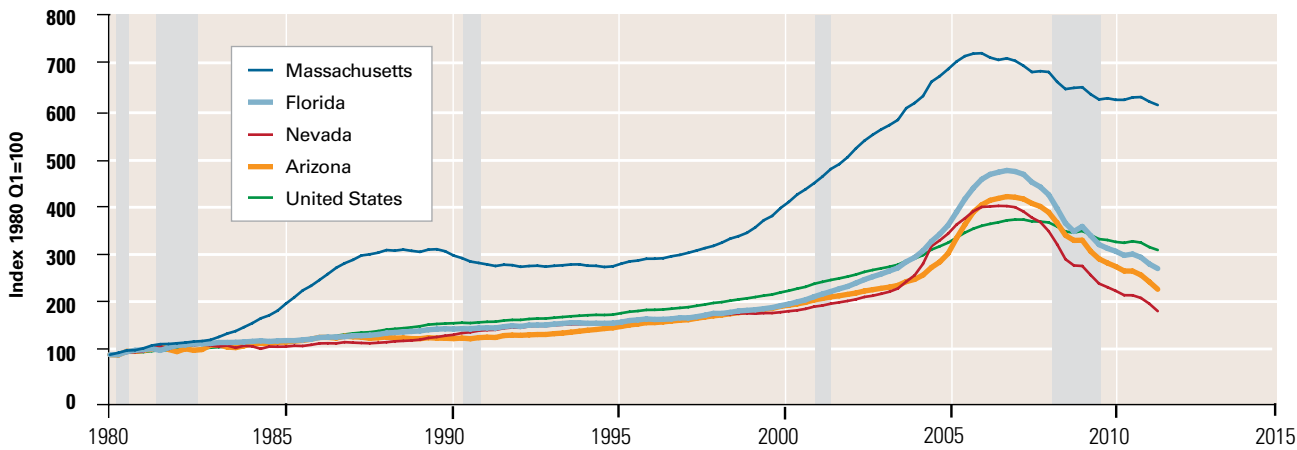
That price declines have been relatively moderate is, of course, not much consolation to the thousands of homeowners across the Commonwealth who have lost their homes to foreclosure. It does, however, help to explain how we could be experiencing price declines

Table 1.
Median Family Incomes by Quintile and Region

Year	Median Grouping	Mass.	Berkshire	Cape and Islands	Central	Greater Boston	Northeast	Pioneer Valley	Southeast
1979	1st Quintile	\$22,452	\$22,260	\$22,372	\$23,026	\$22,691	\$24,591	\$20,983	\$21,749
1979	5th Quintile	\$136,099	\$122,462	\$121,903	\$122,702	\$150,295	\$138,654	\$119,811	\$122,542
1989	1st Quintile	\$24,686	\$22,032	\$23,146	\$24,628	\$26,287	\$26,707	\$19,566	\$24,357
1989	5th Quintile	\$165,982	\$134,961	\$142,439	\$146,285	\$190,156	\$170,927	\$136,118	\$148,231
1999	1st Quintile	\$24,972	\$21,784	\$26,964	\$23,843	\$26,566	\$28,027	\$20,456	\$22,846
1999	5th Quintile	\$192,601	\$143,455	\$163,910	\$159,925	\$226,964	\$204,556	\$144,783	\$157,800
2008	1st Quintile	\$22,688	\$15,792	\$25,187	\$22,988	\$23,188	\$25,986	\$15,992	\$21,989
2008	5th Quintile	\$194,899	\$130,032	\$168,912	\$167,913	\$232,879	\$199,656	\$139,927	\$160,916

Note: Adjusted to 2009 dollars
Sources: U.S. Census Bureau, American Community Survey 2009 and Decennial Census 1980, 1990, 2000; calculations by UMass Donahue Institute

Figure 9. Despite declines, housing prices in Massachusetts remain high
House Price Indices for Massachusetts, Florida, Nevada, Arizona and the United States



Note: Shared areas indicate U.S. recessions
Sources: Case Shiller House Price Index; National Bureau of Economic Research

of this magnitude without improving affordability in any significant way.

Two articles in a recent issue of *MassBenchmarks*¹¹ help to shed light on how this seemingly counterintuitive situation is playing itself out. They remind us that it is not absolute price levels but the relationship between prices and incomes that is the key to affordability. As discussed above, prices have only fallen to 2003 levels and income growth for most households has been anemic in recent years. That is not a recipe for greater housing affordability for the vast majority of households in Massachusetts.

While price declines to date have undeniably created opportunities for potential buyers with relatively high incomes and good credit, for most renters, homeownership in Massachusetts remains well out of reach and tens of thousands of households (owners and renters) across the Commonwealth continue to spend greater than 50 percent of their income on housing costs.¹²

Foreclosures are putting downward pressure on housing prices

Foreclosures in Massachusetts are no longer simply an urban problem. As the Massachusetts Housing Partnership’s Foreclosure Monitor noted late last year, “The gradual movement of distressed properties away from urban areas has reached a tipping point as there are now more distressed units in the suburbs and rural communities.”¹³

The spread of bank-owned properties (REOs) has the insidious effect of muting a recovery in housing prices in many areas of the state. The heavy price discounting typically associated with these kinds of properties makes

it more difficult for both traditional home sellers and for homeowners who have seen their home equity dwindle and in a significant number of cases disappear altogether.

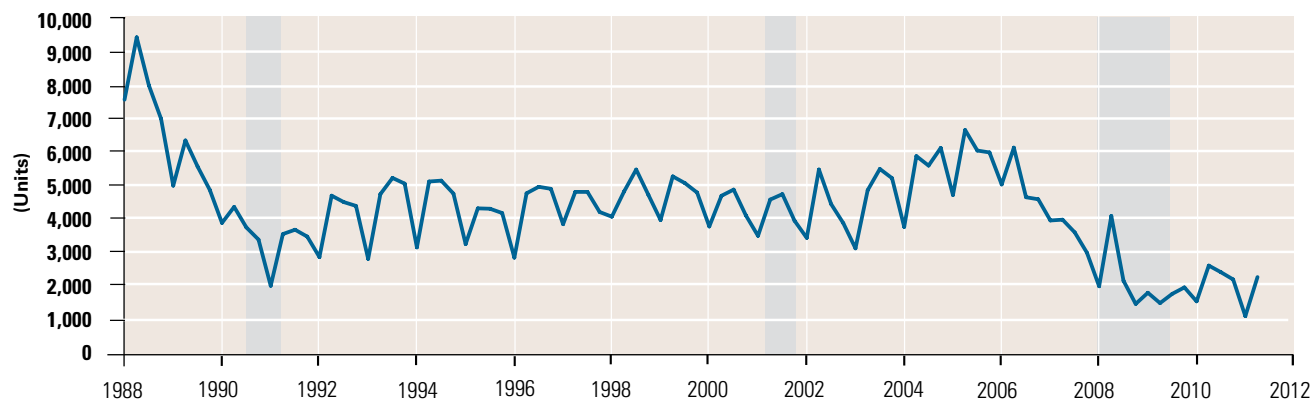
This helps to fuel a vicious circle in which declining prices threaten to push more households into a negative equity position and combined with an uncertain job market provides prospective buyers with a strong incentive to either use their market power and/or wait for further price declines. Additionally, the most common ways in which comparable sales data are used in mortgage lending make it difficult for buyers who may be willing to pay more to obtain financing and further limit the potential for price appreciation. While Massachusetts is clearly in much better shape than many other states in this regard, it is by no means immune from the impact of these forces.

Low housing production is weighing on the embattled construction industry

Even during good times Massachusetts does not produce a lot of housing, in part due to our archaic land-use regulations and zoning codes and widespread local resistance to development of any kind, especially the types of units that can house workers and their families.

While the housing market in Massachusetts remains moribund, the Commonwealth still has thousands fewer housing units than are required for a healthy market given expected job and population growth.¹⁴ This structural shortfall serves to keep housing less affordable and makes it more difficult to attract and retain the next generation of workers and their families. If the Bay State is able to add

Figure 10. Housing starts remain at low levels
New Private Housing Units Authorized by Building Permit for Massachusetts



Note: Shaded areas indicate U.S. recessions
Source: U.S. Census Bureau

jobs more rapidly than is expected, this shortfall will only grow larger in the absence of key policy reforms.

Making it easier to develop more housing would have short-term economic advantages as well. Recent studies¹⁵ have documented the substantial impact that home construction has on the local and regional economy. Significantly, the industries and workers that would most directly benefit from more residential development were hardest hit during the recession and have yet to experience many of the benefits of the economic recovery.

Undoubtedly our inadequate housing supply combined with a dramatic decline in housing starts has helped to limit housing price declines in Massachusetts. However, the large reductions in real estate development activity have taken a serious toll on the blue-collar end of the national and Massachusetts labor markets leading to what Andy Sum and his colleagues at Northeastern University recently referred to as a depression in blue-collar labor markets.¹⁶

Concluding Thoughts

We are living in very uncertain times. In many respects, Massachusetts is at the mercy of economic forces beyond its control and to events transpiring beyond its borders. Turmoil in the Middle East and Northern Africa has led to higher fuel prices, sapping household incomes at a critical time in the recovery. The European Union sovereign debt crisis has the potential to transmit a new financial crisis across the Atlantic. Led by the dire circumstances of Greece, a number of European governments are on very shaky fiscal ground.

Bailouts from the European Union have been conditioned on severe government spending reductions, further depressing the economies of these countries. The U.S. and Massachusetts could be victimized by these developments both through a financial channel and through an export channel as slowing growth or outright decline reduces demand for our exports abroad.

Closer to home, fiscal imbalances at the federal level are expected to lead to budget cutbacks, which can be expected to reduce the flow of federal dollars into the Bay State's defense contractors and research institutions in future years. Massachusetts has historically received its disproportionate fair share of defense appropriations and science funding and is especially vulnerable to budget cutbacks in these two areas.

That said, in many respects the Massachusetts economy is well positioned for future growth. It is home to the best-educated workforce in the nation, it benefits from the presence of some of the world's leading universities and research institutions, and it is a global leader in many of the knowledge-intensive industries that have been and are expected to be growth drivers in the future.

The Commonwealth has been well served by key investments in its K-12 educational system and innovation economy, both of which have been strategic priorities for nearly two decades. However, it is painfully apparent that many of the people and regions of the state are being left behind as the Commonwealth leads the nation out of one of the worst recessions in recent memory and prepares to meet the challenges of a volatile and competitive global economy.

It will take a long-term and persistent effort to extend economic opportunity to a broader array of the

Commonwealth's regions and residents in the years to come and in so doing bring more balance to the Massachusetts economy. Reducing the achievement gap and improving the quality of K-12 education in our cities and low-income rural areas will be a prerequisite for future growth and development in our most challenged areas. Improvements in infrastructure, both physical and civic, also are sorely needed in many of the state's struggling regions and communities.

Improving the economic opportunities for the regions, communities, and hundreds of thousands of Massachusetts families that still await a chance to fully participate in the current economic recovery will not be easy and will not happen overnight. But if Massachusetts is to improve its ability to compete in the global economy and fulfill the promise of being a commonwealth, reconnecting destinies of regions and residents in every corner of the state must become a higher priority for the Bay State's elected officials, business, and labor leaders. 

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