Whither the Recovery? Massachusetts at the Economic Crossroads

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Whither the Recovery?
Massachusetts at the Economic Crossroads

The Massachusetts economy appears to be slowing even as it continues to face considerable headwinds, including federal fiscal policies and international economic conditions, and the sustaintability of the recovery in residential real estate markets.

Michael Goodman & Robert Nakosteen
Introduction

As the second quarter of 2013 comes to a close, the Massachusetts economy finds itself at a turning point of sorts. On one hand, the state economy has consistently outperformed the nation for several years now even as it appears that the Bay State’s growth may track the nation’s for the balance of the year. The state economy continues to recover, but recent employment reports and other data suggest a regional economy that is experiencing steady but modest growth. There are, however, several significant challenges and opportunities confronting the state economy, each of which could have a significant influence on its future.

While the nation avoided falling off the fiscal cliff at the beginning of the year, there was no avoiding the across-the-board budget cuts that went into effect with the implementation of the federal budget sequester in March, which is expected, at a minimum, to further slow the pace of economic activity in the Bay State. At long last it appears that the Bay State’s housing market has definitively begun its recovery, though questions remain about its sustainability. Furthermore, troubling declines in state export activity remind us of how reliant we are on global economic conditions.

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Once again, Massachusetts finds itself at the mercy of federal policy decisions and international economic conditions, not the most reassuring position given the recent track record of our national and international political institutions. But before we turn our attention to an exploration of some of these threats to the economic outlook, some self-inflicted, we will first review the Commonwealth’s recent economic history.

Current Conditions:
The State of the State Economy

As measured by the MassBenchmarks Current Economic Index, after initially bouncing back strongly from the Great Recession the state has experienced a significant slowdown in economic activity. To a certain extent it was inevitable that the state economy would eventually succumb to national economic dynamics; the nation itself continues to perform well below its economic potential. The U.S. economy is still struggling to emerge fully from the Great Recession, precipitated by the bursting of a national housing bubble and exacerbated by the worst financial crisis since the Great Depression.

But midway through 2013, it appears that many of these drags on the national economy are abating. Housing markets are heating up, household balance sheet levels are shaping up, and the national labor market continues to improve, albeit far too slowly to be of much consolation to the millions of workers who remain unemployed or underemployed.

In recent months the state economy has reached a major milestone, the full recovery of pre-Great Recession

Figure 1. Growth in Real Product, Massachusetts vs. U.S.

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employment levels (see Figure 2). While the number of payroll jobs remains over 65,000 below their previous peak in 2001, and tens of thousands of Massachusetts workers remain unemployed, it is clear that the Massachusetts growth premium of recent years has paid off for workers with the skills and experience required by the Commonwealth’s expanding employers.

However, in recent months, employment growth and the decline in the state’s unemployment rate appear to have stalled. This is not surprising given the slowing pace of state and national growth. Despite improvement, major labor market challenges persist and continue to reflect what we have previously described as a “divergence of destinies” in Massachusetts industries, occupations, and regions.¹

As Sum and Khatiavada have pointed out,² the under-utilization of labor as a result of underemployment, the growing duration of periods of unemployment for many classes of worker, and the large reserve pool of workers who wish to work but are no longer active in the labor force remain profound problems for both the Commonwealth and the nation.

The different economic experiences of the state’s regions continue to reflect a very geographically imbalanced state economic recovery. While as noted above, the state has recovered its pre-Great Recession employment level, this development may come as a surprise to some communities outside of Greater Boston, which continue to experience double-digit unemployment rates.

Accounting for Growth in State Output since the Great Recession

The recent release of state-level estimates of gross domestic product (GDP) by the Bureau of Economic Analysis (BEA) begs the question of how the official gross state product numbers for Massachusetts compare with those estimated by the MassBenchmarks Current Economic Index (CEI). The MassBenchmarks CEI is calibrated to track state GDP in real time. Within a multiple regression framework, the MassBenchmarks CEI utilizes statistical relationships between various economic indicators, informed by historical BEA estimates of Massachusetts GDP, to estimate the rate of change in state GDP. While the BEA’s GDP estimates appear with considerable lag, the MassBenchmarks CEI represents a real-time estimate of state economic performance. Figure A presents a comparison of the BEA estimates for Massachusetts with those generated by the CEI. Both estimates are expressed as annual percentage change. For comparison, the annual rate of change in the U.S. GDP is also included.

A number of patterns stand out from Figure A. In one respect, the story of how the Great Recession affected Massachusetts, as told within the pages of MassBenchmarks and in various releases by the journal, is reinforced by the BEA data. That is, the state experienced a milder drop in economic activity than did the nation and recovered more quickly. In fact, the

![Figure A. Gross Domestic Product Annual Rates of Change, U.S., Massachusetts BEA, MassBenchmarks Index](image)

Source: Bureau of Economic Analysis; Bureau of Economic Analysis Real GDP by State; MassBenchmarks Index
BEA data suggest a more emphatic version of this story, portraying modest growth during 2008, a shallower decline than the nation in 2009, and faster-than-national growth in 2010. For the years 2011 and 2012, the BEA numbers describe the state as closely tracking the national pattern of GDP growth, a somewhat different pattern than that described by the MassBenchmarks CEI.

While the reasons for these differences are not entirely clear at this point and warrant further investigation, the devil is almost certainly in the methodological details. Figure B compares the MassBenchmarks CEI to both the BEA state estimates, and the Philadelphia Federal Reserve Bank’s coincident index for Massachusetts. The Federal Reserve Bank of Philadelphia produces current economic indexes for all 50 states using a method similar to that used by MassBenchmarks Senior Contributing Editor Professor Alan Clayton-Matthews when preparing the MassBenchmarks CEI. Significantly, each of the estimates of state GDP depicts the same general pattern. Note that in every year except 2008 the MassBenchmarks CEI estimates more closely track the BEA data than the Philly Fed’s index.
As can be seen in Figure 3, economic conditions on the SouthCoast, in North-Central Massachusetts, and in the Pioneer Valley remain difficult, in part due to the relative lack of the innovation industries that have been driving state growth and a heavy reliance on state and federal spending. The relatively low regional unemployment rates in Berkshire County and on Cape Cod belie continued economic challenges in these regions and remind us that there are two ways to lower one’s unemployment rate, lagging labor force growth being one of them.

Whither Fiscal Drag?

On March 1, 2001, across-the-board budget cuts of federal government expenditures were implemented under the budget sequester enacted in the Budget Control Act of 2011. Absent congressional action, over the next ten years the sequester will reduce federal expenditures by $995 billion with associated reductions in interest payments of $228 billion for over $1.2 trillion in federal debt reduction. Additionally, tax rates for upper-income-bracket households increased as the year began, and at the same time the temporary two-percentage-point reduction in the FICA, or payroll tax enacted to stimulate the economy in 2009, expired.

This reduced level of national spending has imposed a serious fiscal drag on the national economy with significant implications for Massachusetts. Taken together, these changes in federal tax and budget policy are expected to reduce growth of the national economy during 2013 by 1.5 percent. As a relatively high income state, the increased income tax rate for upper income households will affect a larger portion of Bay State workers — about five percent of households earn over $200,000 per year compared with three percent nationally.

The state economy includes many sectors heavily dependent on federal government spending, including defense, university research, and health-care. While the economic impact of these cuts on Massachusetts remains to be seen, there is reason to believe it will be substantial. As Nakosteen and Romitti noted last year:

The Massachusetts economy benefits greatly from the infusion of billions of dollars in direct federal government spending, nearly $84 billion in the most recently reported Fiscal Year 2010. A large portion of these funds go directly to Massachusetts residents in the form of payments like Social Security. Other federal funds are given to the state and local governments to support different programs and efforts. The salaries for federal workers here top $4.5 billion. Massachusetts is also the fifth highest recipient of Department of Defense expenditures, at over $14.5 billion, and much of the state’s prowess for education and innovation leadership is underwritten by an estimated $7.7 billion in federal funding for research and development activities.

Our analysis of job losses resulting from the currently mandated federal budget cuts reaches better than 52,000 over the ten years beginning in 2013. While these job losses pale next to the state’s total employment of nearly three and one-half million, they cut at the heart of the innovation economy of the state. (Nakosteen and Romitti, 2012)
Whither the Global Economy?

A key issue weighing on the state economic outlook is the condition of the global economy. As noted above, the state’s ability to consistently outperform the national economy during this recovery period is largely due to the health and vitality of Massachusetts’ innovation economy. Representing a diverse array of sectors that span information technology, life sciences, advanced manufacturing, and professional and business services, the innovative firms that have been driving our growth of late have done so by exporting their products and services to other parts of the globe.

These powerful export sectors, and by extension the Massachusetts economy, are consequently highly dependent on the international economy. While they have continued to drive our growth in recent quarters despite widespread economic challenges in Europe and Asia, there is good reason to believe that ongoing difficulties in these key export markets may finally be taking their toll on the Bay State’s innovation economy.

The most recent economic forecast for Europe prepared by the Organization for Economic Cooperation and Development (OECD) indicates that the European recession can be expected to continue for at least the balance of 2013 with continued high unemployment expected through 2014. Exports to the Eurozone — a key market for Massachusetts — fell 6.1 percent between April 2011 and April 2012, and an additional 1.2 percent by April 2013. Overall state exports have declined by 11.1 percent on a year-over-year basis (see Figure 4).

Of course, Europe is also a key export market for our Asian trading partners, an important reminder of the interconnectedness of the global economy and the continuing threat to the state, national, and international outlook presented by continuing difficulties in the Eurozone and beyond.

State exports to Asia, which grew by 25.1 percent between April 2010 and April 2011 have declined by 4.5 percent in the past year (between April 2012 and April 2013). While export data do not fully capture what is likely the very substantial international business activity of the Commonwealth’s numerous law practices, business consultancies, and engineering and design firms, the sustained decline in export activity is troubling, suggesting that economic conditions in key markets are having a demonstrable impact on economic activity in Massachusetts.

Whither the Housing Market?

After over seven long years of downturn, there is now every indication that residential real estate markets in Massachusetts have finally turned the corner and have begun to recover after one of the longest periods of decline since the 1930s. In recent quarters sales have increased, prices are rising in the Greater Boston area, and there are preliminary signs that the state’s long-distressed construction sector may be beginning to benefit from renewed demand for new housing construction.

The latest New England Economic Partnership (NEEP) forecast for Massachusetts strongly suggests that the recovery is strong enough to boost construction activity and employment. NEEP is predicting a return to pre-recession levels of housing permits by the end 2014 and growth in construction jobs, which declined 22 percent in Massachusetts during the recession. NEEP expects con-
struction employment growth at an average annual rate of 4.6 percent over the next five years, well in excess of the expected average annual growth in total employment of 1.5 percent during the same period. NEEP is also predicting that the state will regain its pre-recession housing price levels by the end of 2017. Considering that the downturn began in late 2005, that implies a 12-year cycle, the longest since the Great Depression.

While the signs of life in the Massachusetts housing market are unequivocally good news for households that have experienced declines in their home equity and by extension their household wealth, the question of whether it will be sufficient to lift the construction sector out of the doldrums is critical, weighing on the state’s economic outlook. It remains unclear whether this housing recovery is both sustainable and of sufficient strength to spark the creation of a virtuous circle of rising prices and new construction fueled by renewed demand for residential housing.

The Commonwealth’s legacy zoning and land-use policies have historically made it very difficult for developers to respond nimbly to market demand for new housing units. These policies have also stymied the state’s efforts to produce a sufficient supply of residential housing, to maintain an affordable price environment, and to sustain its construction and building trades. As a result, the state’s construction sector is much more reliant on commercial, medical, and university building projects than its counterparts in other regions of the country. Unfortunately, much of the construction in these sectors is supported, either directly or indirectly, by federal spending.

While it is clear that the housing recovery has resulted in some renewed permitting activity from very low levels (Figure 5) outside of large multi-family condominium developments currently underway in the immediate Boston area, it is not yet evident where the new units that will be required to support the expected growth of the construction sector will be located and developed. While housing starts, which reflect the breaking of ground on new developments, appear to have bottomed, recent data suggest that a very slow recovery in construction activity is underway, at least to date.

Even if the substantial pent up demand for residential housing is not met by new construction, there is reason to believe that potential sellers of existing housing units appear to be waiting for prices to rise a bit further before placing their homes on the market (Figure 6). Thus far during the housing recovery, inventories have remained relatively low, resulting in anecdotal reports of multiple offers on existing properties in hot local markets, particularly in Eastern Massachusetts. Fueled in part by low mortgage interest rates and improving consumer finances and confidence, this renewed demand for housing has thus far helped to put some upward pressure on housing prices. Still, clear evidence of a sustainable market response remains elusive.

While prices, interest rates, and indicators of housing demand suggest the makings of a robust housing recovery in Massachusetts, our optimism remains cautious in light of the regulatory restrictions and other factors that may moderate the pace and impact of this recovery of near-term economic activity in Massachusetts. That said, our public- and private-sector leaders can help to improve the chances that the Commonwealth can fully benefit from the long-awaited return of strong economic fundamentals in the housing market. To this end, they can revisit some of the state’s archaic zoning laws and regulations and work to encourage the development of housing where it is needed in response to market demand.

That would help boost the state’s long-suffering building trades and blue-collar sectors. It would also help improve the economic and labor-market outcomes for workers and regions that have yet to experience many

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Figure 5. Privately Owned Housing Permits and Starts, Massachusetts
12-Month Moving Average

Source: Federal Reserve Bank of St. Louis; U.S. Census Bureau Calculations by authors
of the benefits of the state’s economic recovery. And it would help increase the chances that the improvements in housing affordability that have been a silver lining of sorts during the long housing downturn can be preserved as prices rise. This will help ensure that the rising tide does not recreate the affordability problems that were endemic during the upside of what has been a long and painful housing cycle.

**Concluding Thoughts**

At the midpoint of 2013, the Massachusetts economy once again finds itself at a crossroads, with its fate in the hands of national political institutions on both sides of the Atlantic and subject to the whims of the global economy. While there is cause for some optimism, in light of the continued headwinds facing the international, national, and regional economies exacerbated by shortsighted fiscal policies, our optimism remains cautious. There is good reason to believe that the Massachusetts economy may be at a turning point and remains well positioned to ride out whatever comes next. But it remains unclear whether this crossroads will be the last during this long recovery from the Great Recession.

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**Endnotes**


5.) According to NEEP, the housing downturn of the late 1980s, during which prices declined between 1988 and 1993, lasted 9 years. The cycle during the Great Depression lasted 20 years.


7.) Special thanks to MassBenchmarks Editorial Board member (and FDIC economist) Frederick Breimyer for his insightful feedback and willingness to share the data that he tracks on the Massachusetts housing market.

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