

Executive Summary

Introduction

There's a crack in the foundation of the Massachusetts economy, and how wide it grows will depend on whether business and state government can effectively respond to emerging trends that show that despite our state's strong recent economic performance, a growing number of Massachusetts workers have left the state since 1990 in search of better opportunities elsewhere, and many more are working hard but running in place economically.

There is no question that Massachusetts has shared in the national economic boom: workers have made substantial per capita income gains, unemployment is at the lows of the late 1980s, taxes have been reduced, and the business climate has been markedly improved.

This report reveals that most of our state's comparative income advantages are being eroded by our state's high cost of living, and that erosion is beginning to undermine our ability to compete with other states for workers.

But, one true measure of the state's economic performance for ordinary workers and families is whether these advantages, particularly our income and earnings advantages, are translating into higher comparative purchasing power — more money in people's pockets relative to their position in other key states and metropolitan areas. This report reveals that most of our state's comparative income advantages are being eroded by our state's high cost of living, and that erosion is beginning to undermine our ability to compete with other states for workers.

In fact, many workers find themselves running in place — working hard to achieve higher incomes than their national counterparts, but finding, at the end of the day, that their higher incomes don't translate into greater comparative purchasing power.

By far the biggest factor underlying our state's higher cost of living is housing — both home ownership and rental costs. This report explains that Massachusetts home prices skyrocketed in the 1980s, far outpacing our strong income gains. As a result, Massachusetts, and particularly the Boston metro area, has become one of the most expensive housing-cost states in the country, and many young families and new homeowners face one of the high-

est housing cost burdens anywhere in the country.

Strong circumstantial evidence suggests our state's higher cost of living has had a profound effect on the state's ability to attract and retain an educated workforce. Two hundred and twenty thousand people have moved from Massachusetts to other states in the 1990s, during both good and bad economic times. At the same time, we've become increasingly reliant on foreign immigration to replace many of those lost workers. And even with an influx of over 100,000 foreign immigrants in the 1990s, our state's labor force growth rate is one of the slowest in the country. This trend will continue unless the state's business and political leaders address the forces that have led to this exodus.

In this report, we sought to determine how workers' and families' earnings and incomes have changed in recent decades and whether our state's higher incomes and earnings levels translated into more purchasing power for ordinary workers and their families.

The key findings in this report are:

Massachusetts residents, workers, and their families have made substantial income gains over the past two decades, but those gains have been almost completely wiped out by the high cost of living.

- Massachusetts per capita income and median family income growth has significantly outpaced the nation since the late 1970s, standing today 23 percent higher than the national average.
- Unfortunately, the cost of living in Massachusetts is estimated to be 14-17 percent higher than the rest of the country, and a leading business research organization estimates that it's 38-44 percent higher in Greater Boston for a typical "mid-level manager," gobbling up most if not all of our income advantage.
- Factoring in all living costs, the income advantage of Massachusetts residents shrinks to an infinitesimal 0.4 percent, and our national per capita income ranking falls from 4th to 22nd highest. This means that our higher incomes are not translating into increased comparative purchasing power for average Massachusetts workers.

The biggest factor that contributes to our higher cost of living is the high cost of housing.

- Massachusetts now has the third highest housing prices in the country, ranking behind only Hawaii and California. Prices of existing homes in the

state have risen 233 percent since 1980; compared to a 111 percent increase nationally. These high housing costs account for 50 percent of the total cost of living differential between Massachusetts and other states.

- Housing costs have skyrocketed in Massachusetts, far outpacing the growth in workers' incomes. In 1980, the average house price in Massachusetts was 2.75 times the median household income, only a hair lower than the national average of 2.79. By 1990, the average price had jumped to 4.28 times the median household income, while the national average dropped slightly to 2.64.
- The burden is particularly hard on younger homeowners, who bought their homes after the 1980s real estate boom. Housing costs are the 5th highest for someone aged 34 or younger and 17th highest nationally for someone aged 35-44. Older homeowners pay a relatively small portion of their incomes for housing costs, ranking 46th nationally.

The other major contributor to our higher cost of living is our higher tax burden, caused primarily by the impact high marginal federal tax rates have on our state's higher incomes.

- The combined personal tax burden (federal and state income and personal property taxes, excluding real estate) Massachusetts residents pay is roughly 50 percent higher than the national average. In 1996, Massachusetts per capita personal tax payments were \$4,982 versus only \$3,339 for the entire U.S.

For every dollar of taxable income a single person makes over \$26,000 or a married couple earns over \$42,000, the federal government takes a whopping 36 cents in federal income and payroll taxes.

- Massachusetts workers need to make more money to keep up with their national counterparts, but as they do, the federal government takes a bigger and bigger portion of their income. For every dollar of taxable income a single person makes over \$26,000 or a married couple earns over \$42,000, the federal government takes a whopping 36 cents in federal income and payroll taxes.
- State tax experts continue to dispute whether our overall state tax burden is high relative to our national counterparts, once the total mix of state

taxes and fees is taken into account. But what is undisputed is that when the state income tax rate of 5.95 percent is added to the federal tax burden, the combined federal/state marginal tax rate is almost 42 percent for single filers earning over \$26,000 and for married couples earning over \$42,000.

- Our higher tax burden reduces our state's per capita income advantage from 22 percent above the national average (in 1996) to 18 percent.

The high cost of living is hurting our competitive position, and is leading to a brain drain and a heavier reliance on foreign immigration.

- Massachusetts has witnessed a loss of people: 220,000 more left the state for friendlier environs than moved here between 1990 and 1997. The largest group to leave (126,000) was between 25 and 34 years old; 86,000 had college degrees.

The state's anemic growth in its labor force is a potential threat to sustained economic growth.

- Because of this, Massachusetts has become more dependent on foreign immigration to achieve population and labor force growth. In fact, if it weren't for the influx of over 100,000 foreign immigrants in the 1990s, Massachusetts would have experienced a net loss of workers.
- The state's anemic growth in its labor force is a potential threat to sustained economic growth. While the national labor force grew by 8 percent since 1990, the Massachusetts growth rate was 1 percent, ranking 47th in the nation.

The inequality among workers, families, and across counties is increasing.

- In the nation's largest 200 metro areas, families headed by persons lacking a high school degree can expect to achieve a median income of just \$22,000, 46 percent below the national average; since 1979, these workers have experienced a decline in real income of 38 percent.
- In contrast, families headed by someone with a college degree can expect a median family income of \$75,000, 55 percent above the national average. This was the only group to improve their real median incomes between 1979 and the mid-1990's.
- In Greater Boston, families with incomes in the top 10 percent have experienced the largest

Massachusetts Institute for a New Commonwealth

gains, while those in the bottom 10 percent have experienced declines in their real earnings. Family income inequality has been growing since the late 1970s.

- The growth in per capita incomes since 1979 has varied by county from 57 percent in Middlesex County and 52 percent in Suffolk County to 27 percent in Bristol and Franklin counties and 24 percent in Hampden County.

Poverty measures are fundamentally flawed.

- The high cost of living also has an impact on impoverished families, as traditional poverty measurements do not take into account differ-

Massachusetts is losing out on hundreds of millions in federal aid since many of the federal distribution formulas are based on each state's unadjusted per capita incomes and poverty populations.

ences in the cost of living from one region to the next. Once the cost of living is taken into account, our poverty rate jumps from 11.1 percent (the official government statistic) to 14.6 percent, worsening our ranking from 32nd highest in the nation to 13th.

- Massachusetts is losing out on hundreds of millions in federal aid as well, since many of the federal distribution formulas are based on each state's unadjusted per capita incomes and poverty populations.

In the next decade, Massachusetts will be involved in an intense battle with other states to attract and retain workers. But at the moment, we do not appear well-positioned to win this competition. Our high cost of living appears to be encouraging many working-age residents to leave — a phenomenon that at first may seem counter-intuitive considering our strong economic condition. But, any person facing the decision of whether to settle

down in Massachusetts or another state wants to know not just what he or she can expect to earn in each of those states, but how much that salary will buy. The findings in this report do not offer them much encouragement about staying in Massachusetts.

The problem of our state's high cost of living did not arise overnight, and it is certainly not amenable to overnight solutions, but the fact remains that it is now hurting our state's competitiveness in a way that's different than in earlier decades. Strong circumstantial evidence suggests that today's high cost of living is contributing significantly to our loss of many prime-aged workers and working families — who appear to be moving to other states in search of better economic opportunities, lower housing costs and higher overall purchasing power.

As other sources of labor force growth have slowed to a trickle, our state's ability to attract and retain working-age families like those that have left Massachusetts in the 1990s may have a significant impact on our state's overall ability to sustain its economic growth. While labor force growth is not the only factor that will affect future job growth, some companies simply will not continue expanding here if they cannot find the workers to staff their expansions.

State leaders must grapple with these issues as we near the turn of the century. What's needed now is a focus on how Massachusetts' high cost structure affects workers and their families, and a serious debate over the steps we might take to improve the environment for average working families.

What follows is a more detailed description of the key findings in this report. We hope that it offers more than just a look back at what has happened to our economy and our workforce over the past 20 years. We hope it serves as a catalyst for debate about how our state can continue to compete economically for the next 20 years.

Voting with their Feet

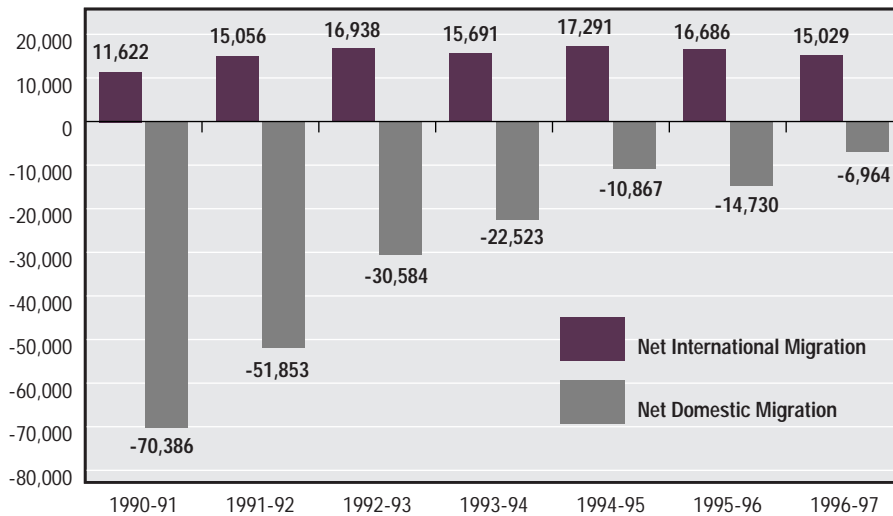
Massachusetts has been losing workers to other states and regions. And it is happening in spite of a strong economy, low unemployment, and some of the highest salaries in the nation.

Every year in the 1990s — both in the darkest days of the steep economic recession and continuing in each year of the current economic expansion — Massachusetts has been a net exporter of people to other states. Every year in the 1990s, more people

have moved out of Massachusetts to other states in the U.S. than have moved to Massachusetts from those same states.

In fact, between 1990 and 1997, U.S. Census Bureau population estimates indicate that 220,000 more people moved from Massachusetts to other states than moved from those places here. Our "trade deficit in people" is most severe with the South Atlantic region, which stretches from Maryland to Florida (net loss of 74,000 people), and with other states in New England (net loss 73,000).

Net International Migration and Net Domestic Migration in Massachusetts, Single Year, 1990 to 1997



Many of the people who left Massachusetts are the kind of well-educated, relatively young prime-age workers any state economy would like to attract and retain. Between 1991 and 1997, we lost an estimated 187,000 people between the prime working ages of 18 and 54, including 126,000 25 to 34 year olds. In that time, we have also lost 86,000 individuals with a Bachelor's or more advanced degree to other states.

While additional research is needed to confirm a cause-and-effect relationship, it appears likely that the higher cost of living in Massachusetts, especially our higher cost of housing, is a major factor in our state's inability to retain our working-age residents and attract workers from other states.

The yearly exodus of workers from Massachusetts to other states should prompt a simple question: If our economy is so good here — if real incomes and wages are rising, labor markets are tight, and employers are hungry for workers — why are more people moving to other states than are moving here?

Reliance on Foreign Immigration

As a result of both the “brain drain” and “brawn drain,” Massachusetts companies are importing their workers. In a little-noticed development, all of our state's net labor force growth from 1986-96 was attributable to new foreign immigration — people moving from outside the US to Massachusetts. Massachusetts has added approximately 112,000 new foreign immigrants between 1990 and 1997.

In fact, were it not for foreign immigration, both the

size of the state's population and our overall labor force would actually be smaller today than they were at the beginning of the 1990s.

By 1996, 13 percent of Massachusetts residents were foreign born, with 7 percent of the state's residents having arrived as a foreign immigrant just since 1980, and 3 percent having arrived just since 1990. Today, roughly one in four children under 18 in Massachusetts is either a first- or second-generation immigrant. And approximately 75 percent of the net increase in the number of families formed in Massachusetts since 1980 was generated by families formed by foreign immigrants.

Our state's growing reliance on foreign immigrants as our main source of labor force growth has gen-

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erated little public attention or debate. Questions about immigration policy — whether at the national or the state level — are certainly prone to demagoguery, and must be approached with civility, respect and sound economic analysis.

However, these debates certainly should not be avoided merely because they may be controversial or misused. All of our state's labor force growth in the last ten years has come from foreign immigration. At a minimum, our state deserves a candid and informed public debate about whether this strategy is one we intend to continue following in the next decade. It should also prompt an examination of what our reliance on foreign immigration means for the many efforts — by government, churches and non-profits — to prepare children and adults for the requirements of citizenship and the jobs of tomorrow.

Slow Growth of the State's Labor Force

In large part as a result of the persistent exodus of Massachusetts residents to other states, the Massachusetts population is growing much more slowly than that of the nation.

This slow population growth is not a new phenomenon: the Massachusetts population has been

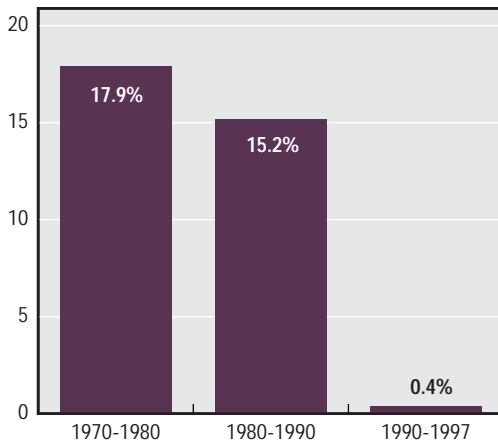
growing more slowly than the nation's since the 1920s. What's different today is that the growth rate of our labor force — the growth in the number of people either working or actively looking for work — is also only a small fraction of the national rate of labor force growth in the 1990s and is considerably below our state's own labor force growth rate in the past few decades.

Our resident labor force has only grown by 1 percent in the 1990s — ranking us 47th in the country, dramatically below the national growth rate of 8 percent.

In the 1970s and 1980s, relatively slow population growth did not hinder our state's economic performance because the labor force experienced steady growth from two other sources: the rising numbers of women and Baby Boomers entering the workforce. Consequently, the Massachusetts labor force grew by 18 percent in the 1970s — and another 15 percent in the 1980s.

But today, the labor force participation rate of women in the state's workforce is leveling off at 63 percent and we've reached the end of the demographic bulge created by Baby Boomers reaching their adult working-age years. The Baby Boomers are being replaced by members of the "baby bust" generation, whose numbers are considerably smaller, particularly in Massachusetts. One of the consequences of the drying up of these two sources of labor force growth, combined with the slow population growth in our state, is that our resident labor force has only grown by 1 percent in the 1990s — ranking us 47th in the country, dramatically below the national growth rate of 8 percent.

Labor Force Growth in Massachusetts in the 1970s, 1980s, and 1990s



In an economy with an aggregate unemployment rate of only 3 to 4 percent, the slow growth rate of our labor force presents a potential threat to continued economic growth. Labor shortages have been growing in the state in recent years, boosting real wages but also adding to the number of unfilled job openings. Limits on future labor force growth may hamper the ability of existing firms to expand and of new firms to locate here.

Changing demographics, both in Massachusetts and nationwide,

will also generate even more intense competition for working-age people over the next decade. Many states, including Massachusetts, will see the average age of their workforce rise — placing a premium on attracting and retaining younger working-age people with college degrees.

At the moment, Massachusetts does not appear well-positioned to win this coming competition.

The Massachusetts Economy: Some Real Success Stories

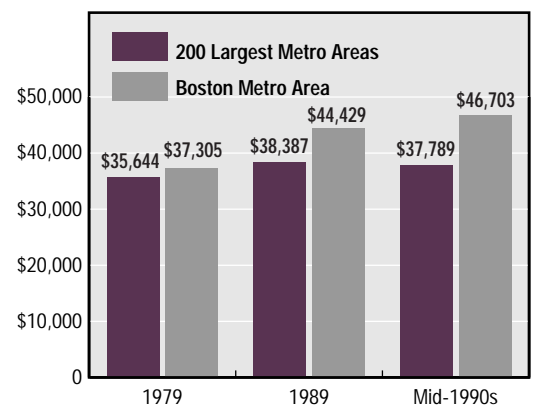
The most direct way to assess why this is happening is to assess whether the income gains generated by the recent economic boom are translating into increased comparative purchasing power for ordinary citizens and their families, i.e. how well are we faring once we have adjusted these incomes and earnings for the higher cost of living in Massachusetts, especially in the Boston metro area.

At first glance, our state economy has made unquestionable progress in the last two decades.

At the end of the 1970s, the income and earnings performance of the Massachusetts economy looked remarkably similar to the national economy. Our per capita and median family incomes stood only slightly above the nation's. Yet in less than two decades, both measures of personal income have jumped from slightly above to 23 percent above the nation's.

In Metropolitan Boston, the results are similarly striking. In 1979, the mean real annual earnings of metro Boston workers was \$37,305 (in 1996 adjusted dollars) — only 5 percent more than the figure for the nation's 200 largest metropolitan areas

Mean Real Annual Earnings of Workers in the Boston Metropolitan Area and the 200 Largest Metropolitan Areas, 1979, 1989 and Mid-1990s (in 1996 Dollars)



Residents, workers and families in Massachusetts have established a clear income advantage over their national counterparts.

(\$35,644). By the mid-1990s, mean annual earnings for metro Boston had risen to \$46,703 — while the average real earnings of the workers in the 200 largest metro areas had grown only slightly to \$37,789 — giving metro Boston a 24 percent advantage.

Findings for all three of these measures make one fact abundantly clear: residents, workers and families in Massachusetts have established a clear income advantage over their national counterparts in the 1980s, and have held onto much of that advantage through the turbulent 1990s — despite suffering through an extraordinarily severe economic downturn at the beginning of the decade.

Trouble Below the Radar

Any person facing the decision of whether to settle down in Massachusetts or another state wants to know, not just what he or she can expect to earn in each of those states, but how much that salary will buy in each of those states.

On this more complex question, the available evidence provides some troubling signs that our state's economic gains have not translated into equally large comparative purchasing power gains for ordinary citizens.

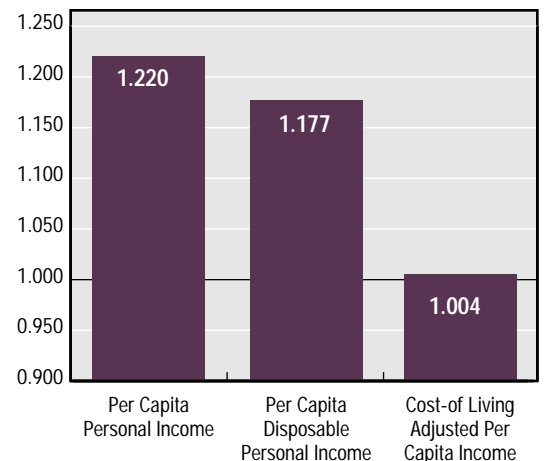
In 1996, Massachusetts' per capita income stood 22 percent higher than the nation's — a fact one might assume would lead to roughly 22 percent more purchasing power for the average Massachusetts resident. But can the average Massachusetts citizen really buy roughly 22 percent more goods and services than his or her national counterpart?

When Massachusetts' per capita incomes are adjusted for our state's higher overall personal tax burden — the combined impact of federal income and payroll taxes, state income taxes and personal property taxes — our state's income advantage shrinks from 22 percent to only 18 percent above the national average.

Because the cost of living in Massachusetts was conservatively estimated on one measure to be 17 percent above the nation's in the 1990s, once our per capita after-tax incomes are adjusted for the higher cost of living in Massachusetts, our income

advantage shrinks to an infinitesimal 0.4 percent — and our national ranking falls from 4th highest to 22nd highest in the country. Use of the cost of living index for mid-level managers compiled by the American Chamber of Commerce Research Association (ACCRA), a national private business research organization, to represent the cost of living for the state would yield an even smaller income advantage.

Three Measures of Per Capita Personal Incomes in Massachusetts as a Percent of the U.S., 1996



This means that, despite what appears to be a sizable income advantage over our national counterparts, once our high cost of living is taken into account, our higher incomes are not translating into substantially increased purchasing power for ordinary Massachusetts citizens, particularly for new and relatively recent home buyers.

Once our high cost of living is taken into account, our higher incomes are not translating into substantially increased purchasing power for ordinary Massachusetts citizens.

Similarly, when Massachusetts' impressive median family income advantage is examined to determine if it translates into higher comparative purchasing power, the answer is again a resounding no.

In 1995, the Massachusetts mean pre-tax family income was \$59,494 — 16 percent above the nation's (\$51,453). However, when adjusted to account for higher federal income and payroll taxes

By the mid-1990s, the average metro Boston worker earned roughly 8-10 percent less in cost of living adjusted terms than his/her national counterpart with identical human capital, demographic and occupational characteristics.

and state income taxes, our income advantage shrinks to only 11 percent above the nation's. Again, adjusting this difference for several estimates of the higher cost of living reduces this advantage to zero.

Unfortunately, the earnings tale for workers in metropolitan Boston tells a very similar story: a large annual earnings advantage that is almost wiped out by the metro area's higher cost of living. By the middle of the 1990s, the mean real annual earnings of full-time, year-round workers in the Boston metro area was \$46,703 versus a mean real annual earnings level of only \$37,789 for year-round workers in the nation's 200 largest metro areas, a difference of 23 percent.

But after the metro area's higher cost of living is taken into account, that impressive 23 percent advantage shrinks to only a 6 percent advantage.

More sophisticated analyses of the annual earnings data show that the main reason workers in the Boston metro area derive higher earnings is because the area's workforce contains a higher percentage of highly-educated workers and a better mix of jobs in industries and occupations that pay above average throughout the entire country. However, once these factors are taken into account, and the cost of living is factored in, workers in Metro Boston actually earn less than their peers with identical characteristics nationwide. By the mid-1990s, the average metro Boston worker earned roughly 8-10 percent less in cost of living adjusted terms than his/her national counterpart with identical human capital, demographic and occupational characteristics.

Thus, the answer to our first question — are people in Massachusetts receiving higher real incomes and earnings than they did 20 years ago — is an unqualified yes. Individual and family income measures show that we've increased our advantage over our national competitors substantially over the past two decades.

However, the answer to our second question — are those incomes translating into increased comparative purchasing power for ordinary citizens — is a

decided no. Our state's higher cost of living is eliminating most of our comparative income advantage. Workers and families may make more in Massachusetts, but those higher incomes do not translate into increased purchasing power relative to their peers in other states and metropolitan areas.

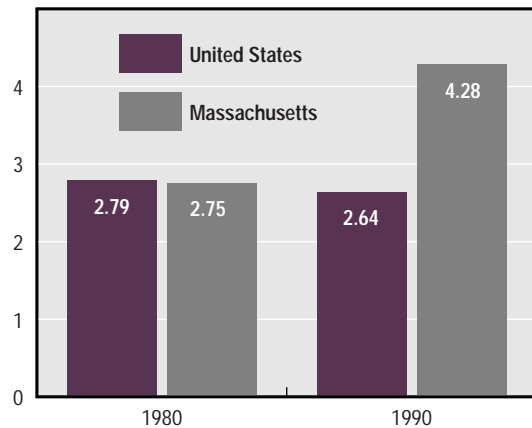
Unfortunately, the evidence suggests that for many workers and families, while their salaries and incomes may be higher in Massachusetts, their purchasing power will in fact be lower here than elsewhere in the country.

Sources of Our High Cost of Living: Housing and Taxes

Many lay readers will read the term "cost of living" and think of things like the prices of "groceries," "gasoline," "health care," "electricity," or other costs of basic goods and services. In many of these areas, prices are indeed higher here than elsewhere. But there are two elements of the cost of living that dwarf the impact of all others on the comparative purchasing power of ordinary citizens, especially for younger families and more recent arrivals to the state. By far the biggest contributor is the high cost of housing — both home ownership and rental costs. The second largest contributor is our higher personal tax burden, primarily the impact of federal income and payroll taxes on our state's higher incomes.

The sharply higher prices of homes have not always been characteristic of the state. As late as 1980, median Massachusetts housing prices were actually slightly below the national average. Using a basic measure of a state's relative housing prices — the ratio of the median home price to the median

Relative House Prices, for Homes with Selected Characteristics, 1980-1990



Metro Boston is now one of the six most expensive housing markets among major metro areas in the country.

household income — nationally, the median house price was 2.79 times median income for households in 1980 — while in Massachusetts, the median house price was 2.75 times the Massachusetts median household income.

However, the 1980s witnessed an extraordinary jump in our state’s average housing prices. In the span of only a decade, our comparative housing prices went from roughly equivalent to the national average to dramatically above it. By 1990, while the national median house price was 2.64 times the national median household income — a slight drop from the 2.79 ratio in 1980 — the Massachusetts ratio had skyrocketed from 2.75 to 4.28 — meaning that the median home in Massachusetts cost 4.28 times the median income of Massachusetts households in 1990.

By 1990, Massachusetts had the third highest relative housing price ratio in the nation — after Hawaii (6.28 times the median state income) and California (5.38 times the state median income). These high housing price ratios were not limited to metro Boston. Lawrence, Lowell, New Bedford, Fall River, Springfield and Worcester all saw their relative housing prices jump dramatically in the 1980s.

Metro Boston is now one of the six most expensive housing markets among major metro areas in the country: topped only by San Francisco, Honolulu, Los Angeles, New York City, and San Diego in the 1990s. For renters, Metro Boston ranked 7th highest in 1990: exceeded only by San Francisco, Los Angeles, Honolulu, San Diego, Washington, DC, and Anchorage, Alaska. More recent 1995 housing price data for metro Boston show similar large differentials over other metropolitan areas.

The substantial run-up in housing prices in the 1980s also created a generational rift that would appear to exert a strong influence on the decision of many young families to move out of the state and on many others not to move into our state. Older families in Massachusetts at the peak of their earnings curve pay a very low portion of their gross pre-tax income on housing — partly because many of

The average Massachusetts resident paid 49 percent more in federal, state and local income taxes and personal property taxes than our national counterparts.

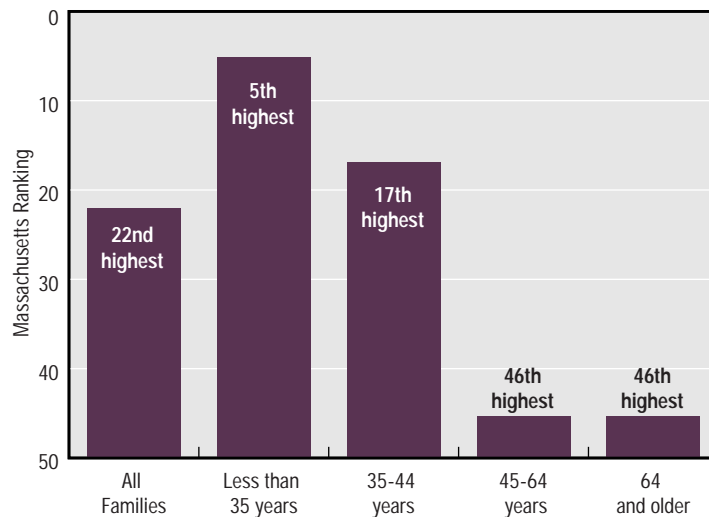
them purchased homes before the 1980s run-up in prices. For homeowners in the 45-64 age group, only 16.5 percent of their gross income was spent on housing in 1990. However, families under the age of 35 paid almost twice that amount — 28.5 percent of their income — on housing, a rate well above the U.S. average.

To the extent that home prices and rents have continued to climb since 1992, these rising prices place the most financial pressure on young adults and families who have yet to purchase their first home. Not coincidentally, this is the same population that is “voting with their feet” by moving from Massachusetts to other states.

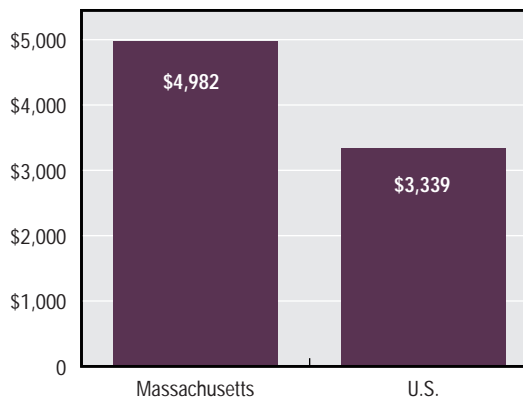
The second largest factor that affects the high cost of living in Massachusetts is taxes — primarily the impact federal and state income and payroll tax rates have on our state’s higher incomes.

During 1996, per capita personal tax payments in Massachusetts were \$4,982 versus only \$3,339 for the entire US — meaning that the average Massachusetts resident paid 49 percent more in federal, state and local income taxes and personal property taxes than our national counterparts.

Ranking of Massachusetts’ Housing Cost Burden Among All Other States, by Age of Family Householder, 1990



Per capita Personal Tax Payments,
Massachusetts vs. U.S., 1996



Federal tax burdens fall disproportionately on Massachusetts citizens for three reasons: 1) our incomes are high relative to the rest of the country; 2) the progressive nature of the federal tax system means that tax rates go up as incomes go up; and 3) the federal tax system fails to adjust for state and local cost of living differences.

High marginal tax rates at the federal level take a large bite of every additional dollar earned, even at fairly modest income levels.

For Massachusetts workers trying to keep pace with their national counterparts, high marginal tax rates at the federal level take a large bite of every additional dollar earned, even at fairly modest income levels. For Massachusetts taxpayers in a “single” filing status, the federal marginal tax rate of

36 percent (combined income and payroll taxes) kicks in for every taxable dollar earned over \$26,000, while for married couple families filing jointly, that 36 percent marginal rate applies when their taxable income reaches only \$42,000.

The size of this federal tax bite is actually estimated conservatively here, and is probably higher for most workers. We have included the payroll taxes that workers pay directly out of their checks, but we have not included the additional portion of payroll taxes that employers pay, even though many academic studies by labor economists argue convincingly that the employer portion is in effect also paid by the employee, through reduced wages.

Add on top of that federal tax bite an additional state income tax of 5.95 percent, and we discover that for many middle-income families, the combined impact of federal and state income and payroll taxes is an effective marginal tax rate of a whopping 42 percent. Even after accounting for the federal deductibility of state income taxes, this means for taxpayers filing as “single,” for every \$1,000 dollars in taxable income they earn over \$26,000, the federal and state government will take roughly \$400 off the top, leaving only \$600 of that \$1,000 in their pocket as disposable income. Similarly, for taxpayers filing jointly, this \$400 bite out of their pre-tax income takes effect when they have more than \$42,000 in taxable income.

A decade ago, a relatively high federal tax burden may have seemed more of a fair trade-off for Massachusetts residents — since the state typically received back more in federal funds than it paid-in in federal taxes. But today, our high relative federal tax burden remains, while the share of federal funds we receive has shrunk as the leadership of Congress has shifted to leaders from the south and west, thereby reducing our share of federal discretionary spending.

At the state level, tax experts continue to dispute whether our state and local tax burden is high relative to our national counterparts, once the total mix of state taxes and fees is taken into account. But what is beyond dispute is that state residents pay a considerably higher state income tax burden than their average counterparts across the nation.

The key fact remains that as a result of our state’s high cost of living, most, if not all, of the higher incomes that people earn here before taxes are being wiped out by our state’s higher cost of living.

Marginal Tax Bite for Single Filers with Taxable Income above \$26,000, or Joint Filers with Taxable Income above \$42,000



And the evidence is clear that housing costs are the biggest factor driving that higher cost of living — followed by the combined impact of federal income and payroll taxes, state income taxes and personal property taxes.

Income Inequality

Another way to identify whether the state economy is uniformly benefiting ordinary workers and families is to assess whether income and earnings gains are being shared widely across the spectrum of Massachusetts workers and families.

Unfortunately, the evidence points in the opposite direction — to a rise in earnings inequality among workers and income inequality among families. Widening per capita income differences also have taken place across different regions and counties within the state.

The gains of the economic booms of the 1980s and the mid-1990s have not been shared evenly across the various regions of the state. In fact, the 495 Belt around metro Boston has done extremely well, while other areas of the state have lagged far behind. One major consequence of these developments has been to widen the gaps between the annual earnings of workers and the per capita and real family incomes in the metro Boston area and the state's other regions.

For example, from 1980 to 1996, the relative size of the annual earnings gap between wage and salary workers in Greater Boston and those in Western Massachusetts more than doubled, while the gap between Greater Boston and Central Massachusetts

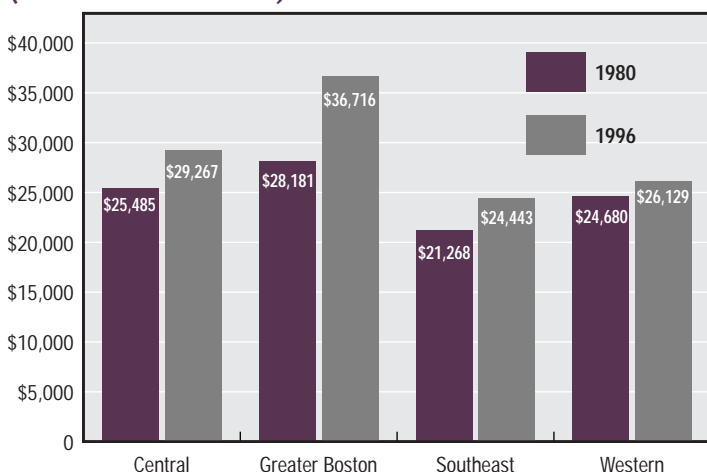
nearly doubled. In 1996, the average annual earnings of workers in the Greater Boston area were 44 percent higher than workers in Southeast Massachusetts, 36 percent higher than workers in Western Massachusetts, and 22 percent higher than workers in Central Massachusetts.

Similarly, families in the Boston metropolitan area have experienced higher gains in their median family incomes than have their counterparts across the state. While in 1979, Greater Boston's median family income was 14 percent above the rest of the state, by the mid-1990s, Greater Boston's median income level had jumped to 22 percent above the remainder of the state. In dollar terms, Boston metro area families now have a median income of \$56,047 — almost \$10,000 more than the rest of the state's average of \$46,069 during 1996.

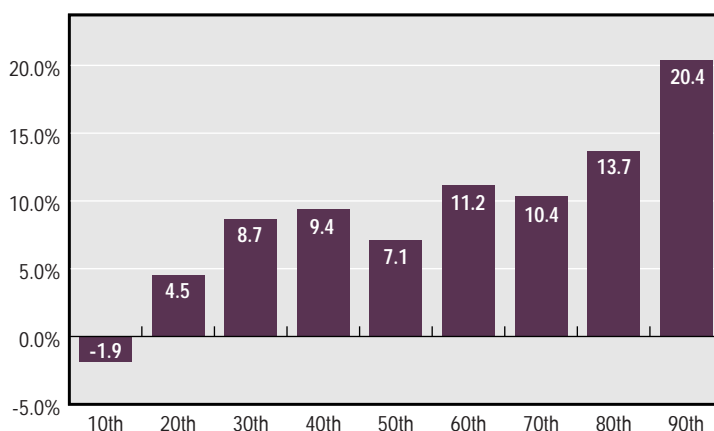
Even among families in the Boston metropolitan area, income inequality has increased substantially. While all but those families in the bottom 10 percent of the income distribution have experienced real income increases since 1979, those in the top 10 percent of the income distribution have experienced the largest gains.

Consequently, families in the top 20 percent of Greater Boston's income distribution increased their share of the total income pie from 39 percent in 1979 to 45 percent by the mid-1990s. Meanwhile, families across the remainder of the income distribution saw their share of the total family income pie decrease. Similar developments in inequality took place across the state as a whole.

Trends in the Annual Earnings of Wage and Salary Workers in Private Sector Firms Covered by the State Unemployment Insurance Laws, by Geographic Region, 1980 to 1996 (in Constant 1996 Dollars)



Percent Change Between 1979 and the Mid-1990s in the Real Annual Earnings of Year-Round, Full-Time Workers at Various Percentiles of the Earnings Distribution, Boston Metropolitan Area



Poverty Problems Worse than Generally Recognized

Another way to measure whether the state's stronger overall economic performance is benefiting all families is to assess our state's progress over time in combating poverty and our comparative poverty rankings.

Existing measurements of poverty problems across states are based on a fundamental and inexcusable methodological weakness: they fail to take into consideration the varying costs of living in different areas across the country. Consequently, current poverty measures are based on the assumption — erroneous to any person, rich or poor, who's ever traveled across this country — that it takes the

same amount of income to escape poverty in Boston as it does in Biloxi, Mississippi or in Butte, Montana.

No less an authority than the National Research Council's Panel on Poverty and Family Assistance recommended, in 1995, that poverty income thresholds should be adjusted, at a minimum, to take into account the wide variation in the cost of securing rental shelter across different regions of the country.

Under existing poverty measurements, Massachusetts's poverty rate has consistently appeared below the national average. Whether at the height of an economic boom (1988 — MA - 8.5 percent; US - 13.0 percent) or the bottom of a recession (1991 — MA - 11.0 percent; U.S. 14.2 percent), the

Ranking the States by Poverty Rates for All Persons Under Alternative Poverty Definitions, 1995*

Definition #1			Definition #2			Definition #3		
Rank	State	Poverty Rate	Rank	State	Poverty Rate	Rank	State	Poverty Rate
1	New Mexico	25.4	1	New Mexico	24.2	1	New Mexico	19.1
2	Mississippi	23.6	2	Mississippi	20.6	2	California	17.0
3	South Carolina	20.1	3	California	19.4	3	New York	16.1
4	Alabama	20.1	4	New York	19.0	4	Mississippi	14.0
5	Louisiana	19.9	5	South Carolina	18.0	5	Florida	13.5
6	Texas	17.6	6	Louisiana	17.2	6	South Carolina	13.3
7	Oklahoma	17.1	7	Florida	16.8	7	Louisiana	13.2
8	West Virginia	17.0	8	Alabama	16.4	8	Arizona	12.8
9	California	16.8	9	Arizona	16.4	9	Texas	12.3
10	New York	16.7	10	Texas	16.3	10	West Virginia	11.9
11	Florida	16.5	11	Oklahoma	15.6	11	Alabama	11.6
12	Arizona	16.3	12	West Virginia	15.2	12	Massachusetts	11.4
13	Tennessee	15.8	13	Massachusetts	14.6	13	Oklahoma	11.4
14	Montana	15.6	14	Maine	14.2	14	Maine	11.2
15	Kentucky	15.1	15	Washington	14.1	15	Washington	11.2
16	South Dakota	14.9	16	Tennessee	13.9	16	Tennessee	11.1
17	Arkansas	14.9	17	Rhode Island	13.8	17	Georgia	11.0
18	Idaho	14.5	18	Vermont	12.8	18	Michigan	10.8
19	North Carolina	12.8	19	Montana	12.8	19	Pennsylvania	10.6
20	Illinois	12.7	20	Illinois	12.7	20	Illinois	10.3
21	Washington	12.6	21	Idaho	12.7	21	Rhode Island	10.0
22	North Dakota	12.4	22	Pennsylvania	12.6	22	Vermont	9.9
23	Pennsylvania	12.3	23	South Dakota	12.5	23	Connecticut	9.9
24	Wyoming	12.3	24	Connecticut	12.4	24	Oregon	9.9
25	Michigan	12.2	25	Michigan	12.2	25	Virginia	9.8
26	Iowa	12.2	26	Georgia	12.1	26	Kentucky	9.6
27	Georgia	12.1	27	Kentucky	12.0	27	Maryland	9.1
28	Ohio	11.6	28	North Carolina	11.9	28	Arkansas	8.9
29	Oregon	11.5	29	Arkansas	11.8	29	South Dakota	8.8
30	Nevada	11.4	30	Oregon	11.6	30	Delaware	8.8
31	Maine	11.3	31	Wyoming	11.4	31	Montana	8.8
32	Massachusetts	11.1	32	Nevada	11.3	32	Idaho	8.8
33	Vermont	10.9	33	Ohio	11.1	33	Ohio	8.7
34	Kansas	10.9	34	Hawaii	10.9	34	Nevada	8.6

*Note: **Definition #1:** Existing Poverty Measures; **Definition #2:** Cost-of-Housing Adjusted Poverty Measures; **Definition #3:** Cost-of-Housing Adjusted Poverty Measures Plus Inclusion of EITC Tax Credits, Food Stamps, and Rental Housing Subsidies in the Money Income of Families.

Massachusetts poverty situation has always appeared to be much better than that of the nation.

However, once the higher cost of living in Massachusetts as represented simply by shelter costs is taken into account, our relative standing quickly deteriorates to a level that indicates still another troubling issue confronting the Massachusetts economy.

Under the existing poverty definitions, the Massachusetts poverty rate in 1995 for all persons was only 11.1 percent, ranking us only 32nd highest in the U.S., and placing us well below the national rate of 13.9 percent. Under an alternative definition that takes into account only the higher cost of rental housing, Massachusetts's poverty rate jumps to 14.6 percent — 0.6 percent above the nation's, and our ranking moves to 13th highest in the nation.

Under a more complete alternative income definition — one that takes full account not just of the high cost of housing, but also of the various in-kind government transfers and tax credits (food stamps, rental housing subsidies, EITC Tax Credits) that some poor people receive — the Massachusetts poverty rate is 12th highest in the country at 11.4 percent — identical to the rate for the nation.

Because billions of dollars of federal assistance to states are distributed on the basis of allocation formulas that rely on each state's poverty levels and per capita incomes, Massachusetts, and indeed many Northeastern states from New Hampshire to Pennsylvania, are receiving less in federal aid than they would if their higher cost of living were taken into account. One of the consequences of this failure is that many of the states in the Northeast with high costs of living and slow population growth are actually subsidizing many of the states in the South and Rocky Mountain regions — where the cost of living is lower and the rate of population growth is much higher.

Conclusions

Given the developments outlined above on incomes, earnings, the cost of living and demographics, what are the implications for businesses and policy-makers as we enter a more unstable economic climate?

It is obvious that the Massachusetts economy has been humming along after suffering through a devastating economic recession from 1989-91. But

The state's high cost of living is a potential threat to the state's future economic growth and competitiveness.

financial turmoil in Asia and a projected slowdown in the nation's economic growth has caused some of our largest companies to pare their workforce. Suddenly, there is the potential for more turbulent times ahead. How is Massachusetts positioned to withstand an economic slowdown?

The state's high cost of living is a potential threat to the state's future economic growth and competitiveness. It is not a good sign that workers are leaving Massachusetts in record numbers during our economic peak. For many working families, high salaries offset the high cost of living. But, for many others, the promise of a better standard of living lies elsewhere.

Business leaders and policy-makers must engage in further study as to why so many workers are voting with their feet and moving out of Massachusetts. If the 220,000 workers who left can't stand New England winters, there's not much we can do, but if they're leaving to find better economic opportunity in the Southwest or the Mid-Atlantic states, then the challenge is to determine how to keep them happy, here.

The recent push by businesses here to lobby the U.S. Senate to pass an immigration bill to double the number of work visas should not be lost on state leaders. With the state's labor force growing at negligible levels, businesses have been importing their labor. In fact, immigrants have accounted for all of the growth in the labor force since 1986. In earlier times, the growing number of women and the arrival of Baby Boomers into the workforce has offset overall losses in population. But, throughout the 1990s, labor shortages have been reported anecdotally across many regions of the state, most notably in professional and scientific/engineering/computer occupations.

This heavy reliance on foreign immigration to meet our labor force needs should prompt a frank, but civil, discussion on the long term implications of this trend. As part of that discussion, we should focus on some of the critical cost factors that appear to be hurting our competitiveness in attracting and retaining skilled workers.

One of the key factors highlighted in this study is the high cost of housing. With housing prices at all

Massachusetts Institute for a New Commonwealth

time highs, it is becoming less and less likely that working- and middle-class people can achieve their goal of owning a home. And with rents among the highest in the country, it is growing more difficult for many low-income workers to find any decent housing arrangement which they can afford.

In recent years, policy-makers have devoted a significant amount of time to reducing the costs of doing business in the Commonwealth. What's needed now is a commensurate focus on how Massachusetts' high cost of living is holding back workers and their families, and a discussion of the steps we might take to improve their lot as an issue of economic competitiveness.

Efforts should continue to be made to reduce the state and federal tax burdens for low- and middle-income working families to increase their after-tax purchasing power.

Much attention has also been paid to the high tax burden workers face, which is the second biggest factor in our higher cost of living. Efforts should continue to be made to reduce the state and federal tax burdens for low- and middle-income working families to increase their after-tax purchasing power. While this issue continually sparks debate over affordability and budget priorities, there is no arguing with the fact that in 1996, Massachusetts residents paid 49 percent more in federal, state, and local taxes than our national counterparts.

Despite the many economic gains made in this most recent economic expansion, the troubling degree of income and earnings inequality first pointed out in our 1996 report *The State of the American Dream in New England* has only continued to grow. If economic gains from growth are not shared uniformly, across either the various regions of our state, or across the various income groups in our state's most prosperous region, our state will continue to struggle to achieve the kind of broad-based economic growth that creates "the

rising tide that lifts all boats." Effort must be made at the state and federal levels to study ways to address these continuing problems.

State policy-makers must also recognize that the federal definition of poverty severely understates the degree to which people are living below the poverty line in Massachusetts. Once the Massachusetts poverty rate is adjusted to reflect the state's higher cost of living, our poverty rate jumps from 11.1 percent to 14.6 percent. Escalating rents are likely to make this problem worse.

This understatement of the poverty level is costing Massachusetts millions of dollars in lost federal aid, another reason for state policy-makers to pay attention to this issue. Since federal formulas take into account each state's unadjusted per capita incomes and poverty populations, Massachusetts and other states in the Northeast lose millions of dollars in aid because of our understated poverty populations.

Finally, our ability to track the success of the state in raising worker and family living standards, and in reducing poverty and income inequality, is dependent on a timely and statistically reliable set of data on labor market developments, earnings and incomes in our state. Unfortunately, the CPS survey — a major source of data on those vital questions — has been substantially reduced in size in our state since 1996 because of federal budget cuts that adversely affected the Bureau of Labor Statistics. This reduction is substantially limiting our ability to reliably track changes in the economic well-being of workers and families across Massachusetts. If we do not address this fundamental information shortcoming promptly, state policy-makers could very well be flying blind as the national and state economies enter the choppy waters of an economic downturn.

We hope that this report's analysis offers a clear-eyed analysis of our state's successes, as well as a portrait of some of the larger structural problems that currently threaten our state's long-term economic health.