

11/12/97

Look Beyond Your Borders: Economic Challenges for Boston  
Cathy Minehan  
Conference with Mayor Menino and city managers  
November 13, 1997

## Introduction: Look beyond your border

The economic health of the city of Boston depends largely on what's happening outside the borders -- in the metropolitan area, the state, the nation, indeed abroad as well. Although the United States, being a large economy, is less buffeted by international forces than many countries, events of the past few weeks show how interconnected we are, as barriers to the flow of goods, services, information, and capital come down.

### 1. Economic outlook

Let's review the **global situation** first.

The International Monetary Fund's forecast expects **world output** to expand by some 4 to 4 ½ percent both this year and next, the strongest pace in a decade. Canada's recovery is strong, and in western Europe, the recovery is broadening from the UK across the continent. We're also seeing robust growth in most of the developing world, including Mexico, this country's third largest trading partner. Although several Asian countries are likely to experience very slow growth for a couple of years because of the recent turmoil in their financial markets, the impact of their problems should be quite modest here in the United States.

Although the pace of world growth will undoubtedly moderate at some point, the IMF believes the current global expansion may be sustained into the next decade. Worldwide inflation remains

subdued and commitments to make progress toward price stability are stronger than at any other time in the postwar era. Fiscal imbalances are being reduced in many countries. And there are still considerable margins of slack capacity to be taken up in some of the advanced economies.

Turning to the **United States**, it doesn't get much better than this. The remarkable combination of solid growth, low unemployment, quiescent inflation, and a declining federal budget deficit seems a sure recipe for a very healthy economy. Over the past four quarters, the economy has grown at a pace of 3.4 percent, well ahead of what most forecasters expected. Reflecting this, and the fact that about 2.5 million net new jobs were added during the past year, the unemployment rate has fallen about half a point to 4.9 percent. These signals of capacity constraint in the face of growth that continues above the long-term trend could signal higher rates of **inflation**. But as yet, we see almost no signs of increasing price pressures. Core inflation has declined almost half a percentage point over the past year to 2.2 percent at an annual rate. One has to go back to the 1960s to find such an extended period of low unemployment and inflation.

Looking forward, the real **fundamentals** continue to look positive. Job growth and personal income are strong, and these are the primary drivers of consumption. **Consumer spending** on automobiles and other retail sectors has rebounded from its

second quarter slump. Similarly, most **businesses** are in good shape as well. Investment spending by firms is one of the principal stars of this business cycle expansion.

Like the national economy, the **Boston metropolitan area** continues to perform remarkably well.

**Employment** in the metro area has grown about 2 percent over the past 12 months, only slightly below the national pace. For Massachusetts as a whole, the recovery has been led by growth in financial services, business services, and construction. At the current pace, employment in Massachusetts should surpass its previous peak of early 1989 in a couple of months. Broadly speaking, the composition of recent job growth is fairly similar to the national pattern. The most marked difference is in retail trade, where Massachusetts, like New England as a whole, is adding retail jobs at substantially less than the national rate. Excess capacity in retailing, which has been noted in the industry for some time, finally led to the closure of a number of chains over the past several months.

Greater Boston's **labor force** is currently growing at a faster pace than it did over the past couple years. With improved prospects for finding a job, labor force participation is rising. This summer, the labor force was 2 percent larger than a year ago. Having recently come down to the lowest levels since 1989, the metro area's unemployment rate is running a point and a half

below the national average.

As for **wages**, our Boston Fed Beige Book contacts -- employers contacted every six weeks or so -- have generally been reporting moderate pay increases. There are pockets of high increases, however, in specialized technical and marketing occupations. Access to highly skilled and experienced technology people thus has become one issue limiting corporate expansion here, as is true in other high-tech centers.

Looking forward, the relatively strong pace of growth has been exceptional, and a modest slowing should take hold as we move into 1998. The reasons lie largely beyond the city's or even the state's borders and reflect national and global economic trends.

The **major challenges** for Boston, and of course the opportunities as well, also sweep in from beyond our borders. I'll touch on four of the most important. The first two are the forces of international trade and the U.S. health care system. The third is the need for greater political cooperation with the cities and towns surrounding Boston. And finally, the critical challenge of improving the quality of Boston's public education.

## 2. International trade

One major opportunity for Greater Boston lies in increasing our already significant participation in the flows of **international trade**. Trade

raises the efficiency with which each trading region uses the limited resources available to it. This increased efficiency improves each region's standard of living. In addition, trade is linked to learning; it promotes technological progress and thus heightens competitiveness and potential growth over the long run.

Nowhere should these benefits be more obvious than in Boston and the Commonwealth, which have few natural resources -- no vast expanses of agricultural land, no iron or coal or oil. For hundreds of years, our most successful exports to other parts of the United States as well as abroad have reflected the **brain-power** of our entrepreneurs and our skilled labor force. For example, Greater Boston's trade is far more dependent on computer-related products such as integrated circuits than the nation as a whole. For many biotech and software companies here, foreign revenues often equal 30 to 50 percent of total revenues.

It's likely that this region also accounts for a disproportionately large share of the nation's growing exports of intangible services such as education, financial services, telecommunications, data base management, and engineering and architectural services.

**Tourism** composes a large and growing piece of Boston's service exports. The city, as New England's hub, has succeeded

in attracting a growing number of foreign tourists who come specifically to shop or ski or, more broadly, to absorb the "New England experience." Foreign tourists reportedly spend more time per trip to New England and many more dollars per person in local stores and restaurants than do U.S. travelers. Looking forward, as foreign incomes grow, foreigners will likely choose to spend increasing shares of that income on travel. And Boston, with its clear comparative advantage in this industry, should be in a good position to benefit.

Unfortunately, a significant part of the media and the public perceive that trade benefits only a few giant multinationals. Many people seem unaware of the gains to themselves as consumers or to the economy as a whole. The resulting **opposition to trade liberalization** undercuts the potential role for the United States in current trade initiatives, such as the rapid development of a Latin American free trade area. Careful studies suggest that **NAFTA** has produced a small net gain in U.S. jobs. Support for the "fast track" **extension** of NAFTA to Latin America, when it comes before Congress again, is clearly in Boston's interest, and not just for the opportunity to ship high-tech capital equipment. Mexico and Argentina are embracing pension reform, following the lead of Chile, and these countries are opening the management of pension funds to foreign money managers. Several Boston-based firms have already established a presence in these markets. Similarly, we have an interest in the World

Trade Organization's current initiative to achieve multilateral agreement on trade in financial services, an agreement which would help open foreign financial markets to local firms.

I recognize that many of you have opposed free trade initiatives because of the impact on some of your constituencies. And it is true that increased trade can leave **some groups**, notably lower-skilled workers and unions, **worse off**. They face reduced demand for their labor when foreign unit labor and other production costs fall below the levels here. Service jobs, moreover, are increasingly exportable. Data entry, computer programming, telemarketing, and hospitable billing can now be done in India, Ireland, or the Caribbean. The adjustments required of individual workers displaced by such competition can be painful.

In this regard, the impact of increased import competition on the U.S. income distribution is similar to the impact caused by technological change. Trade and technological change both improve the efficiency with which a society uses its resources and both increase economic welfare over the long run. In the short run, both exact adjustment costs from vulnerable people. But tariffs, quotas, and other efforts to slow the pace of change make each job saved very costly to society. These efforts, moreover, are unlikely to succeed. Rather than trying to halt the tides of innovation and trade, all of us policy makers have an

important role in helping Boston's citizens to recognize the broad-based benefits of international trade, and giving workers the tools, through education and training, to cope with change.

### 3. Health care

Another major force buffeting Boston, at the national level, is the expanded use of managed and market-oriented health care.

Nationally, the great majority of insured citizens are now covered by some form of **managed care** plan, while the share covered by conventional fee-for-service plans is now a fraction of its former size. Medicare and Medicaid recipients are increasingly being funneled into managed care as well. The forces driving these shifts were the soaring health care costs of the late 1980s and the ever-rising share of the nation's output devoted to health expenditures.

The growing dominance of market forces has brought pressures on the health care industry to **cut costs**. At all levels, insurers and providers have sought efficiencies and market power through consolidation. Throughout Boston and the suburbs, we have seen physicians banding together, and hospitals have eliminated beds, and have acquired or been acquired by other institutions.

The health **insurance** industry has also experienced

considerable turmoil, as some firms have abandoned the health insurance business, and others have become health plan managers rather than health insurers. They too have undergone a wave of merger activity.

With their costs rising faster than premiums, and mergers often providing fewer efficiencies than expected, health plans are increasingly showing signs of **financial distress**. HMO profits have been falling nationally, and some providers in Massachusetts have actually reported losses during the past two years.

There is *some* good news from all of this turmoil. The great success of the shift to market-oriented health care has been the remarkable **improvement in health price inflation**. Nationally, the medical care component of the Consumer Price Index has slowed from double digit rates in the early 1980s to converge with the total CPI in 1997. In Boston, the convergence is less complete, and health cost inflation remains above the national average, but progress has been substantial.

But how long can this favorable trend last? Perhaps not much longer -- with an aging population, ongoing technological improvements in health care that make expensive new techniques possible, and, most immediately, with a growing number of health plan managers reporting losses. Reduced profit

margins for health plans and newly legislated requirements at the state and federal level are putting immediate pressures on health plans to raise premiums. The Congressional Budget Office's most recent projections for private health expenditures suggest that they will grow faster over the next 10 years than they have in the recent past.

Relentless cost pressures also seem to have dampened the growth of **health service jobs** in Massachusetts, indeed throughout most of New England. Massachusetts is still relatively more dependent on health service jobs than the nation, with health care constituting one of every 10 jobs in the Commonwealth, but the recent data suggest some flattening out in their growth here. And the medical sector that's growing the fastest in Massachusetts, home health care, generally pays lower wages than the declining hospital sector.

Just as troubling is the news on **health insurance coverage**. We have seen significant efforts over the past few years to increase coverage, on both the federal and the state level. Despite these efforts, and despite robust economic conditions and a low unemployment rate, the share of the population without health insurance has *risen* nationally and in Massachusetts. To the extent that Boston residents are finding part-time or temporary jobs in retail or in small firms generally, this trend may worsen in the city.

Let me further suggest some health-related strategic issues for the city of Boston and the Commonwealth -- areas where the region may have common interests that differ from those of many other states.

\* We have an interest in keeping federal health-related **R&D** flowing adequately to this region. So far, the National Institutes of Health and other federal agencies have looked with favor on Boston-area institutions, but in an era of tight budgets, we need to make sure the flow of federal funds continues..

\* As a relatively small state with a reputation for generosity in health care, Massachusetts also has an interest in **preventing a race to the bottom** on access to health insurance. Various legislative proposals in the Commonwealth to mandate greater access might create a situation akin to that in auto insurance where insurers punish states by charging higher rates or withdrawing from the state completely. Similarly, large employers could threaten to shift facilities. Instead, *federal* standards might help states to improve access without fear of losing employers or insurers to less regulated areas.

#### 4. Regional cooperation

There are other opportunities for Boston in the realm of health care, and these opportunities can be met by embracing the third challenge I want to pose today -- **greater regional cooperation.**

As an area with high-quality health care, and relatively high

costs, Boston and the surrounding communities have a shared interest in requiring the use of **national quality standards** and outcomes measures -- at least for plans serving Medicaid and Medicare beneficiaries but possibly in the private sector as well. The nation badly needs improved clinical outcomes measures -- to promote efficiency as well as informed consumer choice. With the concentration of expertise in medicine, health plan administration, telecommunications, and database management, greater Boston seems well positioned to seek federal grant money to conduct the studies and design the systems required in developing these outcomes measures and quality standards for the nation.

A related issue is growing concern about the **quality of care** delivered by managed care systems. Patients and purchasers are increasingly aware that the incentives prevailing in the health care system have changed from incentives to do too much under fee for service to incentives to do too little under managed care. When purchasing health care, **joint negotiation efforts** by Boston and other Massachusetts health care purchasers could improve the buyers' leverage on both the cost and the quality front. I understand that Boston and Chelsea have begun such a joint effort. And a wider-reaching joint purchasing effort is one possibility being explored by Mayor Menino's Regionalization Commission, composed of cities and towns in the metropolitan area.

That commission, in fact, strikes me as a promising vehicle for more efficient and effective government in a number of areas. Just as trade barriers are coming down globally, we must be careful not to erect artificial barriers between Boston and its suburbs, or Boston and the Commonwealth. As you consider ways to promote the long-run interests of the city's residents and businesses, attention to the broader context of the metropolitan economy can help avoid myopic or tunnel-vision mistakes. From health care to transportation, trade promotion, and tourism marketing, there are many opportunities for Boston to pursue its own self-interest by reaching for partners beyond the city's borders. Indeed, the city has little choice if we hope to extend prosperity to all of Boston's neighborhoods and residents.

## 5. Education

The last challenge I want to highlight -- **improving public education** -- is perhaps the most critical, because it offers a long-run solution to so many of the economic challenges facing Boston. For example, redoubled efforts on the education and retraining front, in community colleges and within employers, would make it easier for workers displaced by foreign competition to move from jobs in declining industries to positions in growing endeavors. They would also provide businesses with a more ample supply of high-quality, entry-level labor.

Greater Boston's economy has been changing in fundamental

ways that create a growing demand for more highly-educated workers. Boston enjoys strength in a number of “knowledge industries” where new technologies and processes are being applied, and which demand constant learning, flexibility, and innovation. Not the least of the reasons for this strength is our cluster of great universities, which draw the brightest from the entire world to their graduate programs. A fair percentage of the graduates stay in our region.

Accelerated technological change and relentless competition have diminished the value of a high-school degree, at least as measured by subsequent earnings, over the past twenty years or so. But in the new economy, we have come to understand that first-rate college graduates are not enough to ensure regional prosperity. Other businesses are also demanding **higher-order skills** for the many high-school graduates in Boston who don't go on to college. Many companies have adopted some version of “high-performance” work systems, including self-managed teams and techniques to continually improve a process. Mastery of a broader range of skills is necessary for *all* workers who hope to make a significant economic contribution and thereby earn an income sufficient to support a family in the years ahead.

Hence the current efforts to raise academic standards, then measure and reward progress toward them. The leaders who signed the **Boston Compact** in 1982 understood the importance

of a high-quality public school system. With the leadership of Tom Menino and Tom Payzant, we finally see effective reform underway.

In Boston, **School-to-Career** is a key aspect of local education reform, one that I'm intimately involved with through my work as chair of the Private Industry Council. School-to-Career extends the classroom into the work site, effectively lengthens the school days, and builds useful relationships between students and work supervisors, and supervisors and teachers. Best of all, I believe it can make a real difference in the way students approach school and their levels of performance. We have quantitative proof of that difference, in terms of attendance, completion, and academic grades, from Brighton High School. And we are now measuring the performance of all School-to-Career students throughout the system, who last summer numbered 3,915, in 816 Boston firms.

The **Commonwealth's more recent Education Reform Act** also attempts to raise academic achievement for all students, by imposing a core curriculum, higher standards, and challenging new tests in English, mathematics, and science. The tests start next spring for students in the 4th, 8th, and 10th grades. Ultimately, every 10th-grader will have to pass the tests to move on and graduate.

With these reforms, for the first time, we in the Commonwealth will set a benchmark to measure how well students are doing on the state's new academic standards. Since scores will be reported for individual students, schools should have the kind of information they can use to improve their instruction.

Scores for the first few years are likely to be low. Some communities might be surprised by their low scores, and others might feel embarrassed and angry at being singled out. But they shouldn't be. The tests have to be tough, if our public schools are to really prepare students for a job market that is demanding higher skills.

Still, the political fallout from the first wave of tests could be severe. A top priority for Boston's public officials and other local leaders, in my view, is to work with parents now to make the case for higher standards and tougher tests. Communicate your district improvement plans. Besides the state test scores, what other indicators will your schools use to measure academic performance? What are your goals for top students, as well as passing rates for others? Boston's students can, and must, do better. For although education is not a panacea, it is still the best means for an individual to raise his or her standard of living.

I hope this review of some of the challenges affecting Boston proves helpful to you. And I'd be delighted to take questions.