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The Unmeasured Labor Force

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In April 1998 the official unemployment rate reported by the U.S. Bureau of Labor Statistics (BLS) was 4.3 percent. Not since the era of President Richard Nixon had the jobless rate been this low. The BLS also reported that unemployment had remained at or below 5 percent for 13 months running. Not long ago most economists would have considered such an unemployment record impossible to achieve, or at least impossible without igniting an explosive cycle of wage-led inflation. Yet prices have remained under control. During the past three years the consumer price index has risen only 2.6 percent a year--less than half the average annual inflation rate of the 1980s. Moreover, instead of accelerating as the jobless rate dropped, monthly price increases in 1997 were smaller than in the preceding year--only 1.7 percent.

Such a benign unemployment-inflation climate has forced economists back to the drawing boards to try to figure out why reality has seemingly so conspicuously trumped economic theory and what has caused this climate. Improved productivity, particularly in manufacturing, is given credit for helping to keep a lid on prices. Output per hour in the goods-producing sector has been growing at nearly 3 percent a year since 1989--a level nearly half again as large as during the 1970s and equal to the rate during the "golden years" of the 1960s. A decline in transportation costs is another factor. While freight volume continues to grow, its cost as a percentage of GDP has fallen from about 7 percent in 1990 to under 6 percent today. Accelerating costs in such sectors as health care, education, and even legal services are proving susceptible to control by new medical and educational technologies and by information technologies more generally. Inflation rates are on a downward path. Prices in the nonenergy services sector as a whole rose by only 2.3 percent in 1996. By comparison, the lowest rate of increase at any time during the 1980s was 4.7 percent.

The New Labor Supply Regime

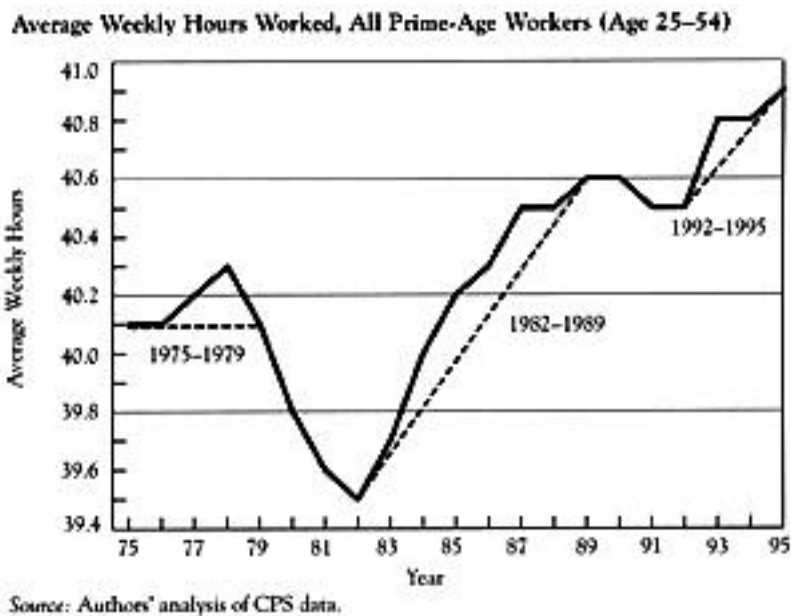
All of these factors clearly play a role in creating the present low-unemployment-low-inflation environment. But we believe there is something much deeper at work. The expansion of global markets, the deregulation of key industries, the weakening of labor unions, and corporate downsizing have generated a greater sense of job insecurity and stagnating or, in many cases, declining family income. And this, in turn, has created a fundamental shift in the nation's labor supply regime. Inflation is kept in check because an increase in the demand for labor as the economy expands is met by an increase in the supply of labor from incumbent workers, that is, from workers who are already in the labor force. The key point is that in this new labor supply regime, Say's venerable law, "Supply creates its own demand," has been turned on its head to become "Increased demand creates its own supply."

Workers now toil as many hours as possible when jobs are plentiful in anticipation of future downsizing and job loss--and they do so at existing wage rates. Moreover, declining hourly wage rates, even in the absence of job insecurity, have forced millions of families to increase their combined hours of work simply to maintain

their annual income. This relieves a significant labor supply constraint that normally accompanies low official unemployment rates. Instead of having to raise wages to attract more workers, firms have increasingly been able to fill their additional need for labor by employing their own workers longer or by offering second jobs to workers who are employed elsewhere. As a result, falling unemployment rates do not necessarily mean that we are "running out of workers" and consequently face imminent wage-price push inflation. Rather, we have an increasing labor supply that keeps a lid on inflation and provides the human resources that can sustain faster economic growth rates.

This is far different from the labor supply regime of the 1970s in which economic growth depended much more on coaxing additional workers into the labor force--a practice that historically had required offering higher wages. This change in labor supply regime raises questions about the theory of the nonaccelerating-inflation rate of unemployment (NAIRU), which argues that if unemployment falls below a certain rate, inflation will result. Even if there is a relationship between unemployment and inflation, one cannot rely on the official unemployment rate as an accurate measure of labor supply. Thus, it may be safe to ignore the unemployment rate and allow the economy to grow.

More important for unraveling the mystery of low unemployment and low inflation is what we have found regarding average weekly hours worked. The graph below shows the trend for prime-age workers since 1975. Of particular note is the remarkably different pattern following the recessions of 1975, 1981-1982, and 1991. Average weekly hours rose between 1975 and 1978, but fell back to their 1975 level by 1979. Essentially, there was no added labor supply coming from incumbent prime-age workers during the strong economic recovery from 1975 to 1979. In the last two recoveries (1982 to 1989 and 1992 to 1995), however, average weekly hours climbed dramatically (indicated by the superimposed slopes). This is a clear sign of a change in labor supply regime, and, as we have suggested, helps to explain the low unemployment and low inflation we have seen in the 1980s and 1990s. Given that the workforce was about 100 million strong in 1982, the increase is approximately equivalent to the addition of 3.7 million new workers to the total workforce, or a reduction of the official unemployment rate by 3.7 percentage points.



The combined hours of work for prime-age families in which both husband and wife work are also up. There is a clear and nearly unbroken trend toward much greater work effort, interrupted only modestly by the recessions of 1971, 1974-1975, and 1981-1982. By 1988 prime-age working couples were putting in an average of 3,450 hours per year in combined employment, up from 2,850 two decades before. This increased work effort, however, has not paid off in earnings. For prime-age working couples as a group, combined real earnings rose by 18.5 percent between 1973 and 1988 (an increase from \$43,851 to \$51,955 in 1991 dollars). These families, therefore, saw their material standard of living increase by just a little bit better than 1 percent per year. Most of this modest increase, moreover, did not come from improved wages, but from working more

hours.

If job instability is on the rise, it could help explain the shift in labor supply permitting wage and price stability to be compatible with low unemployment rates. To measure job stability, we look at employment continuity, or the probability of holding a full-time, full-year job consistently over a period of time; job connection, the probability of being employed by the same employer over a period of time; and work time variance, the variation from year to year in hours worked. We use data from the Panel Study of Income Dynamics (a longitudinal study based on an annual survey conducted by the University of Michigan Survey Research Center since 1968).

Defining "strong" employment continuity as working at least 1,750 hours (50 weeks at 35 hours per week) in 8 out of 10 years and never working less than 1,000 hours in any single year, the results are clear. Job stability is declining. In the 1970s, 79 percent of prime-age men met these criteria, but in the 1980s only 71 percent did so. Individual demographic groups had varying degrees of employment continuity, but for every group except college graduates continuity declined between the 1970s and the 1980s.

How secure individuals feel about their employment is tied to how likely they think it is they will be laid off. Confining the analysis of job connection to men and defining "strong" connection as changing employers in no more than 1 year out of 10, 67 percent of men in the 1970s met this criterion, but in the 1980s only 52 percent did so.

One measure of variance is the proportion of workers having 1 year in 10 in which they work more than 2,400 hours and at least 1 year in which they work 1,750 hours or less (reasonable definitions of overtime and part-time work). The proportion of individuals facing this kind of underemployment has increased by over 5 percent from the 1970s, reaching more than 28 percent for prime-age males in the 1980s. In brief, workers face a "feast and famine" phenomenon in working time with the same Americans both overworked and underemployed.

Taken together, the analysis of strong and weak job continuity and connection and of interyear variance in working time provides the strongest evidence yet of the changing nature of labor supply. As job stability has declined, workers are doing everything they can to protect themselves from interruptions in their earnings. Working as much as they can when employment is available is one strategy that many workers and families have apparently adopted. Hence, as economic growth accelerates and jobs become available, workers expand their hours of work to meet the demand. Simply put, there is a good deal more supply out there than current labor market statistics imply.

Policy Implications

These findings have a number of important policy implications relating to such diverse concerns as the quality of labor market statistics, the potential for welfare recipients to find jobs, and the Federal Reserve Board's reliance on official unemployment rates in setting monetary policy.

To have timely and accurate data that reflect the reality associated with the labor supply regime shift will require paying more attention to a gamut of statistics, some of which are available but not published regularly and others that would need to be collected. The Current Population Survey (CPS) and the Annual Demographic File (ADF), household surveys by the Bureau of Labor Statistics and the Census Bureau, are primary sources of data on labor force participation, unemployment, annual income, and weeks worked last year. Despite the wealth of information in the monthly CPS and the yearly ADF, the Bureau of Labor Statistics normally presents hours of work based on employer surveys rather than on these household surveys. As a result, the monthly labor report often provides a mistaken view regarding working time. The number of hours worked per job can be going down according to the employer survey, while the number of hours worked per worker can be going up according to the household survey. Multiple-job and self-employment hours are not reported in the employer surveys. Thus, if an incumbent worker takes a second job and works 10 hours a week at it, the average workweek reported in the employer surveys will actually go down as the result of the added part-time job. Also, in the CPS household survey, even if total hours of labor supply increase through moonlighting or overtime, neither the number of workers in the labor force nor the official unemployment rate will change.

Since the monthly BLS report stresses labor force participation, unemployment, and hours worked per job, the overall impression will be one of a tighter labor market despite the increase in real labor supply.

This particular problem could be solved by having the BLS report the average workweek from both the household and employer survey data. But there is a bigger issue here. It has to do with the change in the structure of work. With more people working under part-time and part-year contingent contracts, with some increase in moonlighting, and with substantial increases in overtime (at least in manufacturing), the movement toward "nonstandard" workweeks and workyears is growing. Yet the standard statistics hardly measure this.

To remedy this problem, the CPS and ADF should be modestly expanded. Monthly data on second (and third) jobs, types of employment structure, and self-employment could be used to produce more accurate measures of true labor supply, including changes in hours worked by incumbent workers. Undertaking longitudinal surveys could help, since these can track the actual labor market participation of individuals over the business cycle and as they age. We also should consider going back to collecting employer data on layoffs and quits, which was commonplace until the 1980s, but was discontinued by the Reagan administration. Data about how many employment separations are due to the voluntary action of the employee and how many to an involuntary layoff by the employer would give us better information on which to judge job stability and job security.

With regard to concerns about the potential for welfare recipients to find jobs, proponents of welfare-to-work programs are optimistic that, given the almost 2 million net new jobs being added a year, there are enough opportunities for welfare mothers, even for those with the least skill and experience, to find jobs. While many opponents of these programs have criticized their cost effectiveness (because of the expanded need for child care and training), we feel that they may have a more basic flaw--optimism about the prospects for welfare mothers may be misplaced. Based on the research reported here, we do not think that one can conclude from recent job growth and unemployment rates below 5 percent that labor markets are so tight that new, unskilled entrants can easily find employment.

Welfare mothers have never been a monolithic group and some have the requisite skills to find jobs easily, especially when overall unemployment is as low as it has recently been. But Educational Testing Service studies of welfare recipients show that many have quite low proficiencies in core skills (Barton and Jenkins 1995; Carnevale and Desrochers 1998). Therefore, their success in obtaining employment is very much dependent on employers' being so pressed that they are willing to hire people they ordinarily would not. Our view of the current labor market is that it is not as tight as many believe and employers will seek more work from their experienced workers before resorting to new hires, especially those with limited skills. Legislatures will have to revisit assistance programs in the near future as fewer than expected former recipients are able to support themselves.

Finally, and perhaps most importantly, is the implication of our research for macro policy in general and monetary policy in particular. Because official measures of unemployment can no longer be trusted as indicators of overall labor market conditions, it would be prudent for the Federal Reserve to pay little attention to them when it comes to setting short-term interest rates or manipulating the money supply.

We do not think the current climate of job insecurity, job instability, and stagnating wages will soon change. The underlying phenomena of global competition, technological change, weakened unions, and industry deregulation give no sign of dissipating. As such, at current sustainable economic growth rates, over the foreseeable future one can expect a continued upward trend in hours, which will provide the needed labor supply to keep inflation under control. These institutional phenomena will therefore accomplish much of what the Fed might have done in the past to keep price increases in check. Indeed, the Fed might even be able to relax short-term interest rates a bit in a bid to increase growth rates without endangering price stability.

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