

BUSINESS REVIEW

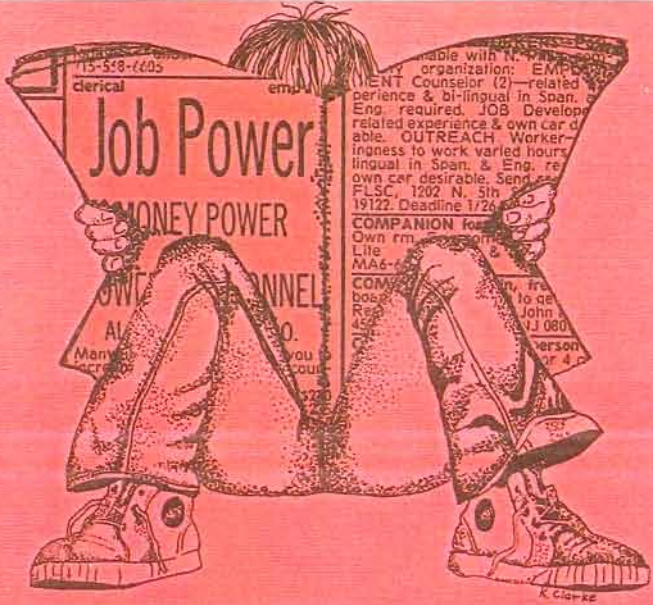
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JANUARY • FEBRUARY 1977



Job Power

MONEY POWER

COPING WITH UNEMPLOYMENT

Local Government
Wages and Services:
How Much Should
Citizens Pay?
Annual Operations
and
Executive Changes

K. Clarke

JANUARY/FEBRUARY 1977

BUSINESS REVIEW

Federal Reserve Bank of Philadelphia
100 North Sixth Street
(on Independence Mall)
Philadelphia, Pennsylvania 19106

COPING WITH UNEMPLOYMENT

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...The simplest measures proposed for dealing with unemployment may not be the best. The author explains why.

LOCAL GOVERNMENT WAGES AND SERVICES: HOW MUCH SHOULD CITIZENS PAY?

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...With the cost of municipal services still on the rise, taxpayers are taking a closer look at the wages and performance of city workers. Local public-sector workers, the author shows, have pulled ahead of industry in wages since 1962. But an infusion of market-type incentives might help improve productivity.

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The Federal Reserve Bank of Philadelphia is part of the Federal Reserve System—a System which includes twelve regional

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Coping With Unemployment

By John J. Seater*

The overall unemployment rate is a favorite indicator of the economy's health. A low rate is viewed as a sign that the economy is vibrant and well, whereas a high rate is considered a signal of economic anemia. This single percentage figure, however, doesn't show who it is that unemployment hits. Nor does it tell us about the economic condition of those who are unemployed. And as an indicator of the business outlook it's often ambiguous because, contrary to popular belief, it sometimes rises when the economy is improving and falls when the economy is sagging. Thus it seems worthwhile to take a fresh look at the unemployment rate to see what it tells us about the overall state of the economy and how it might be affected by government policy actions.

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THE UNEMPLOYMENT RATE: WHAT IT MEANS

Getting a grip on the amount of unemployment in the economy is no easy task. There's no feasible way to add up all the people in unemployment lines, so the unemployment rate is calculated from a sample rather than a complete head count. An individual is considered unemployed if he does not have a job and is looking for one or if he has been laid off from work and is waiting to be recalled. Aside from those waiting for recall, people without jobs and not looking for them are classified as nonparticipants in the labor force (the labor force is the sum of employed and unemployed individuals); housewives, children, and retired people provide the usual examples of nonparticipation. The Bureau of Labor Statistics (BLS)—the agency responsible for collecting labor-market data—has detailed guidelines for deciding whether someone is unemployed (see Box). Armed with these guidelines, fieldworkers go out

BOX

ARE YOU EMPLOYED?

The Bureau of Labor Statistics has detailed guidelines* for deciding who is employed, unemployed, and not participating in the labor force.

Employed. Employed people are all those who, during the week of the survey,

- (a) Did any work at all as paid employees or in their own business or profession, or on their own farm, or who worked 15 hours or more as unpaid workers in an enterprise operated by a member of the family; or
- (b) Did not work but had jobs or businesses from which they were temporarily absent because of illness, bad weather, vacation, labor-management dispute, or for personal reasons, whether or not they were paid by their employers for the time off, and whether or not they were seeking other jobs.

Unemployed. Unemployed people are those who did not work during the survey week, made specific efforts to find a job within the preceding 4 weeks, and were available for work or would have been available during the survey week except for temporary illness. Also included as unemployed are those who did not work at all, were available for work, and

- (a) were waiting to be called back to a job from which they had been laid off, or
- (b) were waiting to report to a new wage or salary job within 30 days.

Nonparticipating. People not participating in the labor force are all those in the population who are not classified as employed or unemployed.

*These guidelines apply only to individuals 16 years of age and older. Younger teenagers are excluded from the survey.

and survey randomly selected households across the nation. Once the data are collected, the BLS can compute the percentage of people surveyed who are in the labor force but unemployed, and this percentage is the unemployment rate. Multiplying the total population figure by the survey percentages gives the total numbers of employed, unemployed, and nonparticipating individuals. Changes in both rates and totals are watched closely by economic and business analysts, but these changes sometimes don't carry any clear message.

An Ambiguous Signal. The unemployment rate can rise for either of two reasons. People can leave employment (on their own initiative or otherwise) and become unemployed, in which case we normally would be justified in saying that the economy had fallen into a slump and was not in the best of health. The unemployment rate can rise

also, however, if employment is constant but nonparticipants begin looking for jobs. Indeed, most economic recoveries go through a stage in which employment and the unemployment rate go up simultaneously: employment rises because unemployed people find jobs, but the unemployment rate rises too because nonparticipants are enticed by the recovery to enter the labor force and begin seeking jobs. In such a case, a rise in the unemployment rate gives a false signal. The economy is improving, but the unemployment rate rises anyhow.

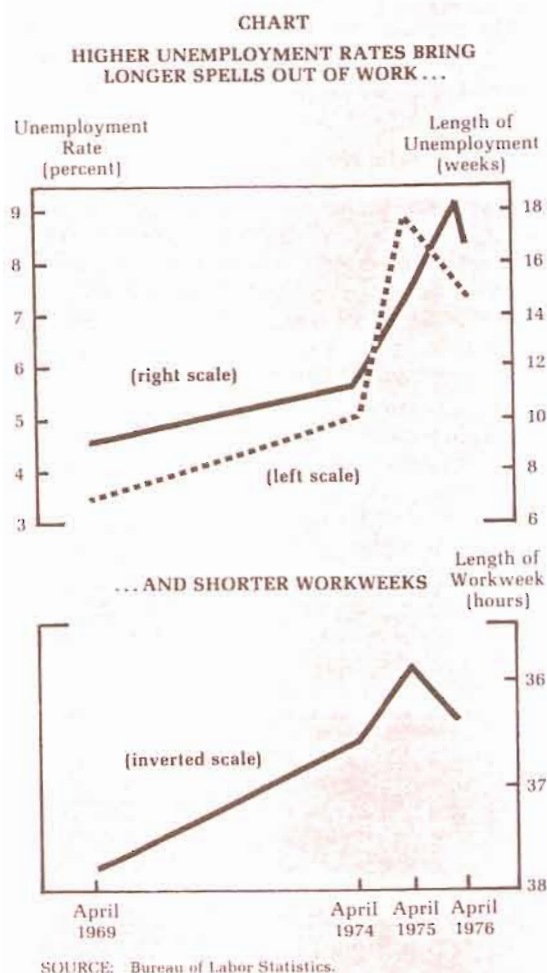
When times are bad, consumers and investors cut back on their spending. Then producers can't sell as much as they'd like to produce and they lay off workers. Unemployment rises and the people who are laid off lose income. But a rise in the unemployment rate carries with it more than just declines in income because of job loss. Even

those who do not become unemployed may suffer through shorter hours or reduced advancement opportunities. Also, a higher unemployment rate typically brings prolonged unemployment to those who are put out of work. In sum, the unemployment rate must be used carefully as a measure of economic health.

Side Effects: More Than Job Loss. Because it reflects only job loss and not side effects, the unemployment rate may fail to convey the gravity of the situation when times are bad. A look at the accompanying Chart shows that when unemployment rates are high, the unemployed remain out of work for longer periods of time. For example, the average duration of unemployment in April 1969, when unemployment was low, was 9.2 weeks, whereas in April 1975, when unemployment was extremely high, average duration was up to 14.7 weeks and still climbing. So as the unemployment rate rises, unemployed workers can expect a longer wait before they begin earning income.

The Chart reveals also that when unemployment spreads, so does a shorter workweek. In April 1969, for example, the unemployment rate was at the uncommonly low level of 3.5 percent and average weekly hours stood at 37.8. By contrast, in April 1975, the unemployment rate was an unusually high 8.9 percent and average weekly hours had fallen to 35.9, almost exactly two hours less than the 1969 figure. When one considers that many employees suffered no reduction in hours at all, it becomes clear that the shortening of hours for those who worked less was considerably greater than the average drop. Clearly, even many workers who remained employed during the 1975 recession suffered a considerable dollar income loss through reduced hours.

There are other consequences. For one thing, a long spell of unemployment may be so discouraging to some people that they stop looking for work and drop out of the labor force altogether. These individuals



are not counted as unemployed because they are not looking for work; consequently, the unemployment rate may understate the severity of a recession. Also, long spells of unemployment tend to discourage or prevent workers from improving or even maintaining their skills so that, even when they do find a job, they are less productive than they otherwise would have been. Other possible outcomes of long spells of unemployment that many people mention and that may have adverse consequences of

their own for society are embitterment and alienation.

Thus a rise in the unemployment rate means more than just losses of jobs, even though job loss probably is the most serious consequence for most people.

WHO IS OUT OF WORK

The unemployment rate figure tells us what percentage of the labor force is out of work, but it doesn't say whether the unemployed are young or old, male or female, rich or poor, white or nonwhite. And since policy actions that tend to bring down unemployment among people with some combinations of these traits might drive up the unemployment rate for others, it's helpful to classify members of the labor force by these (and other) traits.

Age. At any given overall unemployment rate, younger labor force participants suffer a higher unemployment rate than older participants (see Table 1). Indeed, the rate for teenage participants is about six times that for the oldest group of participants. To

some people, the higher teenage rates are shocking, and the disparity between rates for young and old suggests a failure of the economic system to provide equality. A closer look at the reasons for unemployment, however, suggests that the high teenage unemployment rates have at least two simple explanations that should shock no one.

The first has to do with the minimum wage. Teenagers generally are low-skilled workers. Thus an employer will be willing to hire them only if he can pay them a low wage commensurate with their low level of skill. Such a wage, however, may be below the minimum wage required by law and therefore is not permitted. In this case, the employer must choose either to pay a wage higher than he would like or to forego hiring entirely. Some employers undoubtedly choose the latter alternative. Thus many teenagers find employment closed to them because the minimum wage law prohibits their being paid a wage in line with their low skill.

The second explanation has to do with the characteristics of teenagers as members of the labor force. Looking at Table 2 we see that a very large percentage of unemployed teenagers are new entrants into the labor force: they have entered the labor force only recently and are looking for their first jobs. This percentage is 10 to 30 times that for prime-age workers (ages 20 to 65) and constitutes a third to a half of all teenage unemployment. Upon reaching the legal minimum working age or finishing high school, teenagers who want to start work rather than go on to college must spend some time searching for a job. While thus engaged, they are classified as unemployed. Clearly, many teenage participants will not have had the opportunity to work before, either because they were too young or because they were in school. Thus we should expect teenagers in the work force to have above-average unemployment rates and to be new entrants, and this is exactly what we observe. It doesn't follow neces-

TABLE 1*
YOUTHS, WOMEN, AND NONWHITES HAVE RELATIVELY HIGH UNEMPLOYMENT RATES ...

Race	Sex	Age	Group Unemployment Rate (percent)
W	M	16-19	12.24
W	M	20-24	6.61
W	M	25-64	2.24
W	F	16-19	13.04
W	F	20-24	6.66
W	F	25-64	3.62
NW	M	16-19	24.35
NW	M	20-24	11.39
NW	M	25-64	4.01
NW	F	16-19	31.57
NW	F	20-24	14.12
NW	F	25-64	5.58

*Percentages are 1968-71 averages.
SOURCE: Adapted from George L. Perry, "Unemployment Flows in the U.S. Labor Market," *Brookings Papers on Economic Activity* 2 (1972), pp. 245-292.

TABLE 2*
... BUT DIFFERENT GROUPS ARE UNEMPLOYED
FOR DIFFERENT REASONS

Group Unemployment Breakdown (percent)†						
Race	Sex	Age	Job Losers	Job Leavers	New Entrants	Reentrants
W	M	16-19	21	12	32	35
W	M	20-24	43	17	7	33
W	M	25-64	72	13	1	14
W	F	16-19	13	11	46	31
W	F	20-24	25	22	8	45
W	F	25-64	44	14	3	40
NW	M	16-19	21	11	31	37
NW	M	20-24	53	15	8	24
NW	M	25-64	72	11	1	15
NW	F	16-19	11	9	44	36
NW	F	20-24	27	16	12	44
NW	F	25-64	40	15	4	41

*Percentages are 1968-71 averages.

†The last four columns in this table break down the Group Unemployment Rate percentages given in Table 1. Only the last two columns in the present table—New Entrants and Reentrants—are discussed in the text. But the other two are interesting because they show that, on average, unemployed members of some groups tend to have lost jobs much more than unemployed members of other groups. The big losers are not teenagers or women but mature males in the 25-64 age group, and the percentage is the same for white and nonwhite members of this group. The big leavers—those who choose to be unemployed—are in the 20-24 age group; the percentage is highest for white females, followed by white males, nonwhite females, and nonwhite males.

SOURCE: Adapted from George L. Perry, "Unemployment Flows in the U.S. Labor Market," *Brookings Papers on Economic Activity* 2 (1972), pp. 245-292.

sarily that nothing should be done about higher teenage unemployment rates, but they should not be considered abnormal as long as the labor market is structured in the current way.

Sex. Looking back at Table 1, we see that women generally suffer somewhat higher unemployment rates than men. Again, some people find in this disparity evidence of discrimination and lack of equal treatment. But care must be exercised in rendering such a judgment based on unemployment figures alone. Given the role women historically have played in the labor force, we should expect them to have above-average unemployment rates. In the past it has been more likely for a female than for a male participant to be a secondary worker—that is, one who is not the household's primary

source of income. Secondary workers generally are more likely to leave and reenter the labor force, working because they feel like it or because of transitory needs. Such behavior results in higher unemployment rates because it requires the participant to spend time searching for a job each time he or she reenters the labor force. Thus, because women have tended to be secondary workers more than the average, we should expect them to have above-average unemployment rates and to show up as reentrants—and they do. The percentage of unemployed women who are reentrants is about twice that for men. As more women become primary workers, we would expect their unemployment rates to drop relative to males'. Thus we must be careful in using unemployment data as firm evi-

dence of sexual discrimination at present.¹

Income. A recent study by Edward Gramlich has shown that an increase in the unemployment rate has much greater effects on low-income than on high-income earners.² Low-income earners suffer higher unemployment, greater losses of working hours, and greater percentage reductions in earned income.

Gramlich finds that a one-percentage-point increase in the unemployment rate causes an average annual loss among the lowest income earners of about 35 working hours, or about one workweek in a year. Among the highest income earners, the average loss is about 18 hours. These figures lump all groups together—those who become unemployed and thus lose all their working hours with those who lose no hours at all. Because many workers suffer no loss at all, it is clear that those low-income earners who do lose hours must lose, on average, more than 35 hours a year, possibly very much more.

Gramlich finds also that a one-percentage-point increase in the unemployment rate causes about a 4-percent loss in earned income among low-income families compared to about a 1-percent loss among high-income families. Again, these are average figures, so the average losses for those who actually do lose something are higher.

It seems clear from Gramlich's work that even in absolute dollar terms the poor would suffer more from unemployment than others do if it weren't for government transfer payments. This distributional aspect must be kept in mind when one attempts to compute the costs of unemployment.

¹This is not to say there is no sexual discrimination. The point is simply that one must be careful in testing for discrimination. A more appropriate test than merely looking at unemployment rates might be to compare wages of equally qualified male and female workers in identical jobs.

²See Edward Gramlich, "The Distributional Effects of Higher Unemployment", *Brookings Papers on Economic Activity* 2 (1974), pp. 293-342.

Race. It's clear from Table 1 also that nonwhites experience higher unemployment rates than whites. In every age and sex category, nonwhite unemployment is higher than white—usually about twice as high. Furthermore, there is evidence that nonwhites suffer greater income losses than whites for any given increase in the aggregate unemployment rate. Gramlich finds that families headed by black males suffer income losses approximately twice as great as those experienced by families headed by white males. Even among families of the same income level, black ones fare worse in recession, on average, than white ones.

It seems incontestable that one cause of this disparity is racial discrimination. Gramlich finds, however, that the most important factor in explaining the differential of income loss is not race *per se* but rather the relatively low income level of black households. How much of this income differential is caused by current discrimination, such as restricted entry into unions and unfair hiring practices, and how much is caused by the residual effect of past discrimination, such as inferior schooling? So far, no one knows the answer. But in any event, Gramlich's findings suggest that if black income, or at least black earning potential, could be brought into rough parity with that of whites, much of the black/white differential effect of high unemployment rates would disappear.

In short, there is much more to the unemployment picture than the unemployment rate tells us. Unemployment is distributed unevenly to people of different ages, sexes, income levels, and races. Thus policies designed to bring down the overall rate will affect different people in different ways, and policies to reduce unemployment for some may tend to increase unemployment for others. Broad-based policies aimed at total economic activity may not take care of adjusting the distribution of unemployment; for that, specially tailored programs are required.

KINDS OF UNEMPLOYMENT

The unemployment rate fails to reflect not only the distribution of unemployment but also the kinds of unemployment, each of which has its own causes and remedies.

Even in the best of times, some people are counted as unemployed because they're looking for their first job or have quit their former jobs and are looking for something better. Those who pass up low-paying jobs to search for higher paying or more enjoyable jobs are the **frictionally unemployed**.

Again, even in the best of times, some people get laid off because of structural changes in the economy. For example, if consumers decide to buy more TV sets and fewer books, some book editors will lose their jobs and more electrical workers will be hired. Such structural changes occur continually, and it takes time for the newly unemployed to find jobs. These people are the **structurally unemployed**.

When the number of frictionally and structurally unemployed equals the number of job vacancies in the economy, unemployment is said by some economists to be at its **natural rate** and the economy to be at full employment.³ There are enough jobs around for the unemployed, but the unemployed have not yet sorted themselves out and found the appropriate jobs.

When the total demand for the economy's goods and services falls below the sum of everything businessmen want to produce, we have **cyclical unemployment**. If consumers decide to save more and buy fewer automobiles, for example, auto producers, finding their cars unsold, will lay off workers. Such layoffs may not be matched by new vacancies elsewhere in the economy, however, because demand is not merely shifting from one market to another but rather is decreasing in the total of all markets. Thus, when total demand for goods and services falls below total supply,

³Thus, full employment is not the same as no unemployment.

the number of unemployed exceeds the number of vacancies. It is this type of unemployment that broad-based fiscal and monetary policies are aimed at.⁴

WHAT CAN GOVERNMENT DO?

Government may be able to eliminate cyclical unemployment by using monetary and fiscal policy to stimulate the total demand for goods and services. As demand rises, producers hire idle labor. Many economists believe, however, that once unemployment falls to the natural rate (the sum of the functional and structural unemployment rates), government cannot permanently reduce it further with aggregate monetary and fiscal policy. If these economists are right, attempting to do so would cause unemployment to fall **temporarily** and then rise back to its natural rate accompanied by a permanent rise in the rate of inflation.⁵ According to this view, once unemployment has reached the natural rate, the only way to lower unemployment over the long haul is to reduce the natural rate itself. This could be done with job training programs, permanent public works projects, and information services that help the unemployed locate available jobs. Should such programs aimed at reducing the natural rate be undertaken? This may seem to be a strange question. After all, unem-

⁴It is possible also that total demand will exceed what businesses plan to produce and the economy then will suffer from cyclical overemployment (vacancies outnumber the frictionally and structurally unemployed). To prevent inflation, the government then should pursue restrictive policies to restrain the pace of aggregate demand. Thus, the purpose of monetary and fiscal policy is to prevent unemployment from deviating from the natural rate in either direction.

⁵Actually, there is considerable controversy in the economics profession regarding the natural rate of unemployment. Many economists would disagree with part or all of the view expressed in the text. For a more detailed discussion of these issues, see John J. Seater, "A Perspective on Stagflation," *Business Review*, Federal Reserve Bank of Philadelphia, May 1975, pp. 19-30.

ployment is bad, so programs to reduce it must be good, right? Not necessarily.

Attacking Unemployment. At the natural rate, a major cause of unemployment is lack of information. The jobs are out there, but the people who are looking for them don't know where they are or what the going wage is. They may not even know just what kinds of jobs are available. Employers, similarly, have vacancies but have to look for suitable employees and must figure out just what to pay them. It takes time for employers and employees to get sorted out. This time could be shortened if employers or employees were willing to invest more time and money in training programs, information dissemination and collection, and so on. The fact that they don't invest more time and money suggests that they don't find it worthwhile to do so—the costs exceed the gains.

Consider, for example, an apparel worker whose job has been eliminated. Among other choices, this worker can either start searching for another job right away or go back to school and learn a new skill. Going to school would cost money for tuition and would require her to forego any income she could earn by finding a job instead of attending school. Suppose this worker decided to start searching right away after calculating that the costs of school exceed the benefits. She may have miscalculated; maybe school would be the right choice in her case. But she collects as much information as she can about the apparel industry and alternative industries and then makes her best guess as to where her prospects lie.

Now suppose the government decides to reduce unemployment by subsidizing training programs and paying part of the unemployed apparel worker's tuition if she decides to go to school. By reducing the cost of going to school in this manner, the government will entice some apparel workers to go to school who otherwise would not have gone, and unemployment will be reduced.

This seems like good policy, but is it? To justify such intervention, some would argue, we must assume that people in government are better judges of how resources should be allocated than are private individuals, each acting in his own interest. The government administrators would have to know better than the unemployed apparel worker, for instance, that the proper thing for unemployed apparel workers to do is to go to school. Thus, from a pure efficiency point of view, one could argue that programs to reduce the natural rate would be economically unjustified.

Other economists disagree and offer a counterargument, pointing out that inefficiencies and imperfections such as those caused by labor unions, monopolies, and government programs and regulations, already modify economic behavior enough to make the natural rate incompatible with getting the most economic output from our present set of inputs. Unemployment compensation is a good case in point: it modifies economic behavior by reducing the unemployed worker's incentive to find a new job. To the extent that these kinds of intervention occur, programs to reduce the natural rate may improve the allocation of resources by offsetting the distortions of present intervention. But it also may be that attempts to lower the natural unemployment rate will exacerbate inefficiencies.

Still other economists would argue that even if the natural rate of unemployment is efficient, it's not equitable, and considerations of equity require that some efficiency be sacrificed to ease the burdens of unemployment on the disadvantaged.⁶ So at pres-

⁶For example, many people are concerned about the relatively high rate of nonwhite unemployment and feel the government should intervene to reduce this rate. For a detailed discussion of these equity and efficiency issues, see Edmund S. Phelps, *Inflation Policy and Unemployment Theory* (London: W.W. Norton, 1972), and Edward C. Prescott, "Efficiency of the Natural Rate," *Journal of Political Economy* 83 (1975), pp. 1229-1236.

ent there remains some disagreement about the appropriateness of government actions to lower the natural rate of unemployment.

Whether or not the government should make an effort to reduce unemployment below the natural rate, it can use monetary and fiscal policies that stimulate economic expansion to combat cyclical unemployment. Such policies, however, take time to work; in the meantime, people remain unemployed and earn no income. The government can and does alleviate this condition by providing unemployment compensation.

Compensating the Unemployed. Unemployment compensation has become increasingly comprehensive since its institution in 1935. The percentage of the work force covered has increased steadily, and benefits have become more generous and easier to obtain.

At the time unemployment compensation was enacted, only one-half of one percent of the work force was covered by private compensation plans. By 1958, however, all 48 states, Alaska, Hawaii, and the District of Columbia had unemployment insurance plans covering some 64 percent of the labor force. And by 1975, coverage had increased to 77 percent of the labor force. Most states now have maximum benefit levels of at least 50 percent of the state's average weekly wage. The waiting period to qualify for benefits has fallen from 3½ weeks in 1936 to less than 1 week in 1975. The duration of coverage has increased from 11½ weeks in 1935 to 27¼ weeks in 1975.

In fact, the maximum duration in many states is much higher than that used to compute the above averages. These averages were based on permanent legal maximums. The recent recession, however, induced several states to enact temporary legislation which increased the maximum period to 52 weeks. These temporary increases have been extended several times so that, in many states, the maximum payment period has been 52 weeks for 3 or 4

years. Recently, some states have increased this temporary maximum to 62 weeks.

Although unemployment insurance may replace up to 60 percent of disposable income for many individuals, it's estimated that all assistance programs together—including several not usually considered to be unemployment compensation, such as aid to families with dependent children—replace on average only between 20 percent and 33 percent of income lost through unemployment. (Those with higher income get the smaller replacement.) The reasons for these low averages are that a sizable fraction of the labor force is not covered by unemployment compensation and that unemployment programs deal only with losses of income resulting from unemployment and not from shortened hours. Nonetheless, it is clear that unemployment compensation substantially reduces the burden of unemployment.

A MATTER OF EMPHASIS

Thus government can and does act to contain some kinds of unemployment, but not all kinds can be reduced to zero at any realistic cost. Some frictional unemployment, for example, is normal in an unregulated society where people can choose when they're going to look for their first jobs or when they're going to quit one job and look for another. Some structural unemployment is normal, too, as long as it remains impossible to foresee all economic disturbances, from ups and downs in resource availability to breakthroughs on the technological front. Both of these kinds of unemployment occur even when there are enough jobs for all the people who want to work—when unemployment is at or below its natural rate.

When unemployment is above its natural rate (the sum of frictional and structural unemployment rates) because of the workings of the business cycle, government may be able to reduce the excess by using monetary and fiscal policy. But once cycli-

cal unemployment has been brought down to the natural rate, it can be reduced further permanently only by lowering the natural rate itself. And so far, the issue whether or not to lower this rate—by whatever means—remains debatable.

In short, unemployment is a complex matter, and the unemployment rate figure fails to convey this complexity. It may well be time to shift the emphasis from this one

measure—the overall (and overworked) unemployment rate—to measures of unemployment that capture the different classes of cases on a fairly fine-grained grid. Doing so might give policymakers a new start in their quest to determine what mix of government and private-sector initiatives would contribute most, at any moment, to alleviating the burdens that unemployment sometimes brings.

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