

## The Unemployment Rate: Time to Give It a Rest?

By Stewart Schwab  
and John J. Seater\*

The most overworked figure in our society may be the unemployment rate. Newscasters, politicians, and economists use it in discussing everything from the overall health of the economy to the merits of alternative welfare programs. Despite its widespread use, however, the unemployment rate frequently is criticized for not indicating the true state of the economy's health or of society's welfare.

If the unemployment rate falls to 4 percent, for example, some economists will argue that it's too low and that, even though the rate is greater than zero, the economy is overemployed. Others will argue that

unemployment has not fallen far enough and that, although the overall rate is fairly low, the rates for blacks and teenagers are much higher. Each group has a point; but one and the same statistic is being used for two quite different purposes.

The first group uses the unemployment rate as an economic measure. These people are interested primarily in the overall state of the economy. Are we in a recession or a boom? Where are we headed? How fast? People with the second viewpoint use the unemployment rate as a welfare measure. They are interested primarily in how the benefits of the economy are distributed. Who is suffering? How bad off are they? The different concerns of these two groups can and often do lead to different policy prescriptions based upon the same reported overall unemployment rate, even though both groups may complain that the unemployment rate is an imperfect measure of what they're concerned with.

If the unemployment rate is so over-

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worked and imperfect, perhaps it should be figured a different way, or replaced, or at least supplemented by other statistics. Just what changes should be made depends on whether the objective is to construct an economic measure or a welfare measure.

### THE UNEMPLOYMENT RATE AS AN ECONOMIC MEASURE

The unemployment rate is calculated by dividing the number of unemployed people (roughly, those without jobs but looking for employment) by the total number of people in the labor force (the sum of employed and unemployed people).<sup>1</sup> A high unemployment rate is considered a sign of economic dislocation; when the rate climbs, a recession may be in the offing. A low unemployment rate is taken as a sign of good economic health; after recessionary periods, falling rates signal recovery. That's the idea, at any rate. But in fact it's not so easy to link the state of the economy to the unemployment rate after all, because of measurement difficulties, business cycle fluctuations, and uncertainties about what rate of unemployment is normal.

**Measurement Difficulties.** Several peculiarities of labor-force behavior that the unemployment rate fails to capture make the rate less useful than it might be as a measure of economic health.

One of these is part-time employment. The official unemployment rate counts all part-time workers as fully employed. Many of these part-timers would prefer to work full-time, but they cannot do so because of slack work, material shortages, repairs to plant and equipment, or inability to find full-time work. Such workers really are partially employed and partially unemployed. There are other part-timers who want only part-time work and really are

partially in the labor force and partially out. The government reporting system doesn't consider how much part-time employees would like to work; instead, both kinds of part-timers are counted as wholly employed when the unemployment rate and labor-force participation rate are calculated. Thus the unemployment rate tends to be understated.

It might be better to divide part-time workers between employment and unemployment, or between employment and non-participation, according to the fraction of the standard workweek that they're on the job. For example, suppose the standard workweek is 40 hours and consider a worker who would like to have a full workweek but who, because of a slowdown, can work only 10 hours. This worker could be counted as one-quarter employed and three-quarters unemployed. Four such workers would be equivalent to one fully employed and three fully unemployed workers. Similarly, a part-timer working only 10 hours by choice would be counted as one-quarter employed and three-quarters non-participant. Counting full-time equivalents would give a clearer picture of unemployment.

Underemployment is something like part-time employment, but it's much harder to track. People use the expression 'underemployment' to refer to the condition of those who are employed below their training or capabilities. A chemistry Ph.D. employed as a dishwasher is an example of the kind of thing people have in mind and worry about when they refer to the loss to society from underemployment. But the mere fact of being employed in a job that uses only some of one's acquired skills needn't make an individual underemployed or justify a modification of the unemployment rate. Virtually everyone has some skills that aren't used.

If we were to count the chemist-dishwasher's unused chemistry skills as unemployed, then we really should not count his dishwashing skills as employed;

<sup>1</sup>The totals are calculated from samples. For a description of the calculation see John J. Seater, "Coping With Unemployment," *Business Review*, Federal Reserve Bank of Philadelphia, January/February 1977, pp. 3-4.

otherwise, we should be treating him as two people—an employed dishwasher and an unemployed chemist. Moreover, the fact that the chemist-dishwasher couldn't get a job as a chemist but did get one as a dishwasher suggests that society simply does not value the services of another chemist as highly as the services of another dishwasher. Thus, from a social point of view, it would be inappropriate to place more value on his chemistry skills than on his dishwashing skills—which is implicitly what we would be doing by counting him as underemployed or partly unemployed.

Still another peculiarity of labor-force behavior that the unemployment rate fails to capture is the condition of would-be workers who, after spending time looking for a job and finding nothing, get discouraged about their prospects and drop out of the labor force altogether. In a recession, the number of such discouraged workers rises considerably and keeps the unemployment rate down somewhat—which tends to make economic conditions look better than they are. Thus, for purposes of measuring the health of the economy, it would be useful to count them as unemployed.

But there's a difficulty here. Discouraged workers are identified as those who would like to work but have gotten tired of unsuccessful search. This is a very vague standard, because some people want to work more than others and so try harder to find work, while some get tired more easily than others and so give up searching for work relatively early in the game. Also, how much available jobs will pay and the kind of work offered affect how soon some people become discouraged. Because the standard for discouraged workers is so vague, it probably is best not to try to modify the unemployment rate to account for them, even though policymakers may want to keep tabs on them in some other way.

Movements in the number of discouraged workers, part-time employees, and underemployed individuals may well reflect a

shift in the pace of economic activity; but because of measurement problems, the unemployment rate will not reflect this change accurately. And there is another way in which the unemployment rate may give false signals about the economy's health. Sometimes the unemployment rate will change with no accompanying shift in the state of the economy. One example of this is the long-run shift in the composition of the U.S. labor force. Since the Second World War, the United States has seen an increase in the percentage of women and youths participating in the labor force. For various reasons, women and youths have above-average unemployment rates.<sup>2</sup> As they become a larger part of the labor force, they drive up the overall unemployment rate. But the resulting increase in the jobless rate doesn't signal a deterioration of economic health; it reflects a change in the composition of the labor force.<sup>3</sup>

Thus, the unemployment rate is an inaccurate meter of the pace of economic activity on two counts. Sometimes the economy moves, and the jobless rate doesn't. On other occasions, the unemployment rate shifts, but the economy's condition is unchanged. There are still more distortions of the linkage, however, such as complications introduced by business cycle fluctuations.

**Business Cycle Fluctuations.** The rise and fall in business activity (the business cycle) can distort the unemployment rate's representation of the state of the economy. For example, when the economy begins to slow down, many firms hang on to their workers instead of laying them off right away. The managers give their workers less

<sup>2</sup>In recent years, female participants have been seeking more full-time, long-term employment than they used to. As their labor-force behavior has become less distinguishable from that of men, the effects of changes in the sexual composition of the labor force have diminished.

<sup>3</sup>Seater, "Coping With Unemployment," pp. 6-8.

work to do and more idle time until they can figure out whether the slowdown is a short, random pause or the beginning of a more serious downturn. Only after they have become convinced that a recession of some duration has started do firms lay off large numbers of workers. A firm's employees represent a considerable investment in recruiting and training, so it's hardly a trivial matter for a firm to cut back or increase its labor force.

Thus the economy can begin to decline with little change in the unemployment rate because firms hoard their workers. It might be helpful therefore to correct the unemployment rate for these hoarded workers. Some attempts at this have been made, but in practice such correction is difficult because of data limitations.

Another phenomenon that clouds the interpretation of the unemployment rate is that the size of the labor force changes over the business cycle. For example, when the economy begins to climb out of a recession, jobs open up, unemployed people find employment more quickly, and the unemployment rate tends to fall. But the improved economic picture also encourages many nonparticipants to enter the labor force and look for jobs. While these new entrants and reentrants are looking for work, they're classified as unemployed, so their attempt to find work tends to increase the unemployment rate. Thus when the economy starts moving out of a recession, there are two forces working in opposite directions on the unemployment rate, and it may rise even though the economy is improving. Indeed, Geoffrey Moore, director of business cycle research at the National Bureau of Economic Research, argues that, because the labor force increased as the job picture improved during the 1975 recovery, the unemployment rate rose despite an improvement in labor market conditions.<sup>4</sup> Thus business cycle

fluctuations make it even harder to read off the state of the economy from changes in the unemployment rate.

**An Elusive Benchmark.** A final difficulty with using the unemployment rate as an economic measure comes from our not knowing what rate is normal. The fact that people are unemployed does not mean that the economy is in poor shape. Because information about available jobs (or, from the employer's point of view, about people available to fill jobs) isn't easy to get, it takes time for people looking for jobs (and employers looking for workers) to sort themselves out, and so some unemployment always will be with us. But at what point does the level of unemployment give a clear sign of overall economic health or weakness?

Many economists look for this benchmark where the number of unemployed equals the number of vacant jobs, because then there are enough jobs to go around even though the labor market hasn't matched workers to jobs. When the number of unemployed equals the number of vacancies, unemployment can be said to be at its natural rate. A lower unemployment rate means more vacancies than people to fill them, so that employers bid against each other to obtain the scarce workers, which can ignite inflation. A higher unemployment rate means too many workers for the available jobs, which leads to recession and deflation. When unemployment is at the natural rate, the economy is at full employment.

It follows that if we want to use the unemployment rate to measure the state of the economy, we should look at how the current rate differs from the natural rate. If this difference is positive, then unemployment is too high and the economy is in recession; if the difference is negative, the unemployment rate is too low and the economy is headed for inflation.

The main problem with this approach is that it is difficult to know what the natural rate of unemployment is. Many economists

<sup>4</sup>*New York Times*, October 2, 1975.

believe that it's about 5 percent, but estimates vary considerably. Thus although the concept of the natural rate may be useful as a broad policy guide, it is not yet of much value in making detailed policy changes.

In short, this uncertainty about the level of the natural rate is another reason—along with measurement difficulties and the effects of business cycle fluctuations—for regarding the unemployment rate as an imperfect measure of economic health. Fortunately, there are several other labor market statistics that could either supplement or substitute for the unemployment rate.

#### **IMPROVED MEASURES OF ECONOMIC HEALTH**

Considering the kinds of unemployed people makes it easier to see the effect of labor force changes on the unemployment rate. The Bureau of Labor Statistics splits the unemployed into four groups: job losers, job leavers, new entrants into the job market, and reentrants who are looking for work after a period of absence from the labor force. New entrants and reentrants are the ones to watch here; these are the people formerly outside the labor force who now have decided to look for work, perhaps because prospects for employment look better than before. And indeed, reentrants tend to make up a larger share of the unemployed as the economy recovers. For example, in June 1975, during the depths of the latest recession, reentrants accounted for 31.1 percent of all unemployed; by December, with the recovery proceeding well, that figure had risen to 38.1 percent.

Because the overall unemployment rate is calculated from the size of the labor force at survey time, the overall rate cannot be corrected to reflect changes in labor force size over a period of time. In order to take these size changes into account, it's necessary to substitute other measures of economic activity for the overall unemployment rate.

One such measure might be the rate of job losers. This rate is based on the number of people who have lost their jobs and are looking for work; it is the number of job losers divided by the sum of job losers and employed people. Even though these laid-off workers make up only a third to a half of all people looking for jobs, they are the ones most commonly thought of as unemployed. The main advantage of using the job losers rate to analyze business cycles is that it screens out most of the misleading fluctuations caused by changes in the size of the labor force.

A second measure that eliminates much of the influence of labor force size changes is the unemployment rate for married men. Married men from school years to retirement have a very strong attachment to the labor force, and this attachment hasn't varied greatly for several decades. Thus this group's participation rate changes little, so the group's unemployment rate is more likely than the overall unemployment rate to reflect cyclical changes in the economy.

A third, and perhaps the best, labor force figure to use in gauging the health of the economy is the employment ratio. This is not the ratio of employment to the labor force (the employment rate), which would be just the complement of the unemployment rate and would suffer the same problems as the unemployment rate. Instead, the employment ratio is the ratio of the number of employed people to the total working-age population. The advantage of this measure is that it is not influenced directly by people's entering or leaving the labor force. Rather, the employment ratio focuses on the number of jobs held by workers and ignores labor force participation. Thus, if businesses hire more workers, the employment ratio goes up. (At the same time, the unemployment rate could be holding steady or even rising.) Of course, the employment ratio would have to be corrected for many of the same errors and oversights as the unemployment rate—labor hoarding, part-time

workers, and so on. But it appears that if this were done, the employment ratio would do quite well as a measure of economic health.

Thus, in statistics such as the rate of job losers, the unemployment rate for married men, and the employment ratio, economists and policymakers have measures of economic health that could be used along with the unemployment rate or even could replace it entirely. Using these other statistics would make it easier to get a line on economic health, at least, and that's one side of the unemployment issue. What about the other side?

#### THE UNEMPLOYMENT RATE AS A WELFARE MEASURE

The unemployment rate is used not only as a measure of the overall health of the economy but also as an indicator of the state of society's welfare. Obviously, the health of the economy has a bearing on welfare. When economic activity slackens, most people suffer, including those still employed. Some people lose their jobs; others are denied salary increases or enjoy fewer opportunities for advancement. Because the unemployment rate is used as an indicator of economic health, it also is used as a welfare indicator.

But economic health is only one component of society's welfare. Another component is fair distribution of burdens during periods of economic slowdown. There are several ways of trying to get at this issue. Some consideration of unemployment by groups might be useful. Similarly, information on the duration of unemployment or changes in the proportion of families falling below some poverty level might tell us something about the distribution of burdens associated with higher unemployment.

The age, race, and sex breakdowns provided by the Bureau of Labor Statistics can be quite informative. In December 1975, for example, the overall unemployment rate was 8.2 percent; but the rate for blacks was

more than 50-percent higher than that, and teenagers had an unemployment rate more than double the overall rate. The rate for black teenagers was four times the overall rate. Many people are concerned about these disparate unemployment rates and feel something should be done about them. Although the overall unemployment rate is not likely to be of much use in discussing these issues, group figures would be.

Yet group breakdowns focus on only certain subsets of society. And they fail to tell us whether the same individuals (either within groups or across groups) bear all or most of the burden of joblessness or whether there is some sharing of the cost of unemployment via high job turnover. In this regard, however, it could prove useful to look at information on the duration of unemployment.

Even if the overall rate is moderate and even if the distribution of unemployment among groups is more or less even, the impact of unemployment on unemployed individuals depends in part on how long those individuals are unemployed. If most unemployment is less than a month or two, people may not suffer greatly from being unemployed. But if many of the unemployed are jobless for a long time (if unemployment turnover is low), then much social distress may result from unemployment even though the aggregate rate is not especially high. The welfare problems associated with long-term unemployment are obvious. The lack of income becomes more acute as savings dwindle, and feelings of rejection and helplessness become more severe.

It's important not to assume, however, that long duration of unemployment always produces severe undesirable consequences. Much unemployment is voluntary in nature. Some people quit their jobs to look for better ones; others enter the labor force to see if there's anything to their liking. In a recent article in the *Wall Street Journal*,<sup>5</sup> a housewife looking for a job was quoted as

<sup>5</sup>*Wall Street Journal*, February 7, 1977.

saying: "I'd be working right now if I wasn't so fussy about the kind of work I'd take. I'm not looking for a job because I need the money, so why shouldn't I be choosy?" The article goes on to record that, of the 7.6 million unemployed Americans in December of 1976, 3.4 million, or 45 percent, were women, and of these the majority were married to men earning \$10,000 a year or more. Now \$10,000 is not an especially high income, but it is well above the official poverty line and also above the lower-level budget computed by the Bureau of Labor Statistics.

Thus it seems fair to say that some of the long-term unemployed are not in dire economic straits and therefore do not have as strong a claim for public assistance as others have. Yet these comparatively well-off unemployed people drive up the average duration of unemployment as well as the unemployment rate itself, and they tend to distort the picture painted by the duration figures. Unfortunately, it's impossible to correct the duration figures for such people, simply because it's impossible to decide who needs a job to escape suffering and who doesn't. And so, although these figures may be useful in measuring the impact of unemployment on the unemployed, they are far from being a completely reliable guide to changes in society's welfare.

In short, group breakdowns and duration figures are useful only when, and insofar as, they match up with income level, which is a reasonable proxy for human welfare in the economic sphere. Thus it seems clear that since the unemployment rate and these other measures depend for their usefulness on their rough connection with income level, the most direct approach to measuring welfare would be to go straight to an income-level measure. Such a measure is available in the low-earnings rate.

#### **THE LOW-EARNINGS RATE: A BETTER WELFARE MEASURE**

The low-earnings rate, besides including unemployed people, includes those who

earn less than a certain annual income—the working poor. The argument for including the working poor is that, although employed, such people still suffer many of the welfare burdens of the unemployed.

A difficulty with constructing a low-earnings index is determining the cutoff for low earnings. Some people suggest the poverty level, which is based on a definition developed by the Social Security Administration in 1964 and revised by a Federal Interagency Committee in 1969. Others argue for the Bureau of Labor Statistics lower-level budget, which is considerably above the poverty line but still hardly a luxury budget. Which level to use is a matter of social choice, depending on how much income society judges to be minimal.<sup>6</sup>

A second difficulty is deciding whom to include in the index. One possibility is to consider anyone making less than the minimum acceptable income as having low earnings. This approach focuses on *individuals*. Another possibility is to consider only those *families* making a substandard income as having low earnings. The separate incomes of a husband and wife might be below the minimal level for individuals, but taken together these incomes might exceed the minimal level for families.<sup>7</sup> The family

<sup>6</sup>For an attempt to construct a low-earnings index, see Sar A. Levitan and Robbert Taggart, "The Hardship Index," *Across the Board* 13, 11 (November 1976), pp. 55-60. Their index—the Employment and Earnings Inadequacy Index (EEI)—is the ratio of subemployed individuals with below-average incomes to the total labor force. (The subemployed include the unemployed, discouraged workers, involuntary part-timers, and heads of households whose wages are below the poverty level; the labor force includes discouraged workers.)

Using the EEI, Levitan and Taggart calculate that the percentage of the population suffering hardship rose from 10.5 in 1974 to 13.5 in 1975. Although this looks like a sharp increase, the EEI rose much less rapidly than the unemployment rate over the same period. Because of the way it's computed, the EEI would have had to rise to over 25 percent to match a several-percent rise in the jobless rate.

<sup>7</sup>Families generally enjoy economies of scale in living costs; for example, it costs a man and a woman less to live together as husband and wife than to live single.

measure probably is the superior one, but, of course, adjustments must be made for family size. A family of four requires more income than a family of three. Corrections to account for family size can be made without much difficulty. Thus despite minor obstacles, the low-earnings rate has an important role to play in calculations of human welfare.

#### AN OVERVIEW

The economy can be looked at as a big pie. Most economic policy issues are concerned with increasing the size of the pie. But there are also many distributional issues concerned with how the pie will be sliced and who will get what slice. The overall unemployment rate is used in analyzing both sets of issues, but, as we have seen, it isn't entirely appropriate for either. Certainly, economic health and social welfare are related to one another; but they are not identical. Consequently, it can be misleading and confusing to use one figure—and a crude one, at that—to summarize both conditions. Thus at least two supplementary measures are required—one designed for measuring the state of the economy, the other designed for dealing with how society's welfare is changing. The employment ratio and a low-earnings ratio adjusted for family size may be the respective measures to use.

There is a wealth of other information available that adds detail and richness to the evaluation of policy options. Some of this information can be used to correct the present employment and unemployment

statistics, and some of it can be used in a supplementary way. Each statistic gives its own unique insight into the state of economic affairs, and for some purposes it would be desirable to report all statistics to the public routinely. But the average voter doesn't have time to sift through a raft of economic details to inform himself on the state of the economy or the plight of the poor. He wants a summary—one or a few measures that will be easy to understand and will summarize economic and welfare conditions quickly, even if imperfectly. The best course may be for economists to improve the employment ratio and the low-earnings ratio, weeding out as many as possible of the omissions and biases noted above, and then report these figures together as measures of the state of the economy and the state of general well-being.<sup>6</sup>

In any case, policymakers and economists need to give the unemployment rate some relief. The rate often is criticized for not telling the whole story, but the rate cannot possibly tell all by itself. Other figures must be used to supplement it. And perhaps if more attention were given to these other figures, the many policy issues connected with unemployment would be better understood.

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<sup>6</sup>This is not to suggest that any information should be suppressed or withheld. Rather, the point is that *routine* reporting of a single statistic should be replaced by routine reporting of a few selected statistics, in order to give a more accurate picture of both economic and social welfare than that given by the unemployment rate.



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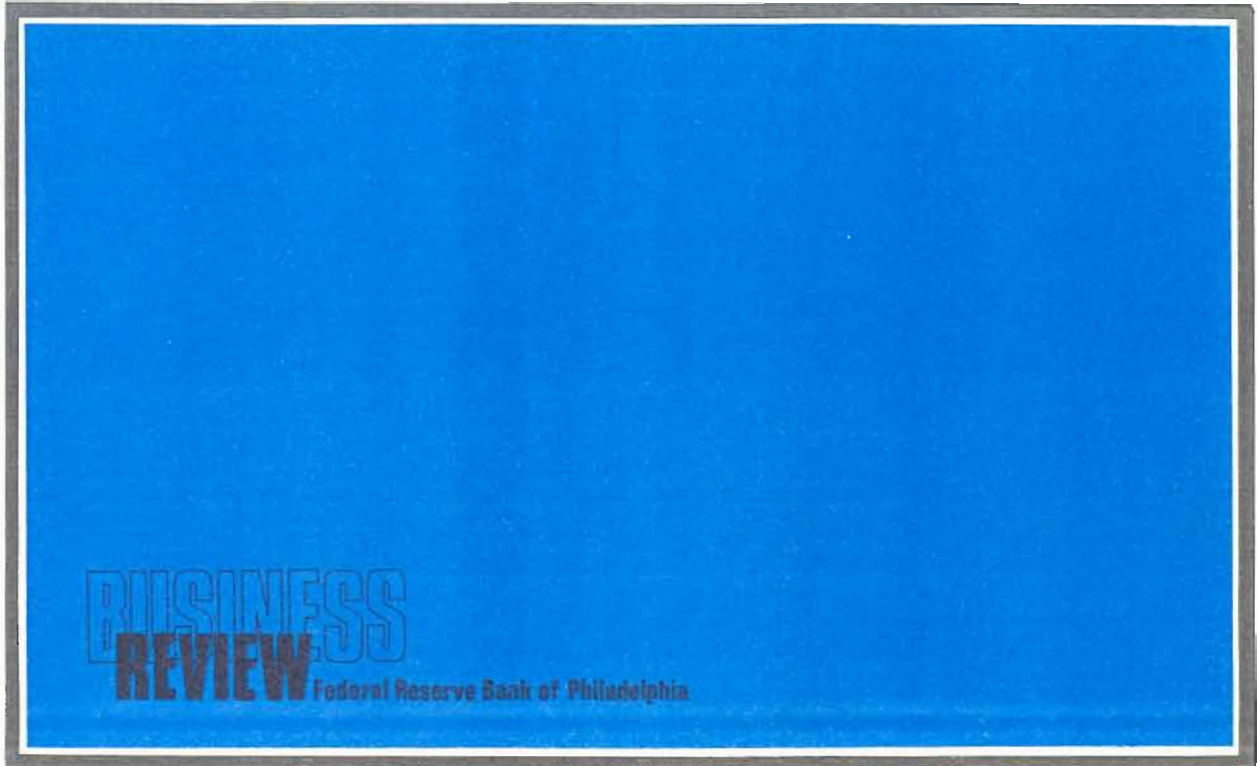
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