
FRBSF WEEKLY LETTER

November 6, 1987

The Great American Job Machine

A remarkable feature of the current economic expansion, the longest peacetime expansion on record in the United States, has been the large decline in the civilian unemployment rate from its postwar peak of 10.7 percent in December 1982 to 5.9 percent in September 1987 — the lowest level in eight years. This decline is even more remarkable when contrasted with the performance of the Organization for Economic Cooperation-Development (OECD) countries. The weighted average unemployment rate of the major European Economic Community (EEC) countries — Belgium, Denmark, France, W. Germany, Ireland, Italy, Luxembourg, the Netherlands, and the United Kingdom — rose steadily from 2.6 percent in 1970 to 11.5 percent in 1986 (Chart 1).

The difference between the U.S. and OECD countries is more striking when employment is considered. From 1970-1986, overall employment grew by 36 percent in the U.S. but fell by 0.6 percent in the EEC countries. Furthermore, a greater proportion of employment growth here has been full time. Contrary to popular impression, the current expansion has not been based primarily on an expansion of part-time jobs. The unemployment rate for full-time workers fell from its peak of 10.6 percent in the fourth quarter of 1982 to 5.6 percent in the third quarter of 1987, while the unemployment rate for part-time workers fell from its peak of 11.0 percent to 8.2 percent over the same time period.

By any indicator, the labor market in Europe has performed much more poorly. This *Letter* attempts to ascertain why.

Labor market rigidities

The simplest explanation, and a popular one, attributes the employment differences to the relative rigidities of the respective labor markets. The American economy is characterized by a relatively more *laissez faire* approach in contrast to the numerous regulations and welfare provisions of the European economies. From the employers' point of view, mandatory work benefits reduce the demand for labor. In Europe, payroll taxes amount to roughly 20 percent of

wages, as against 7 percent in the U.S. The relatively greater expansion in part-time employment in Europe also is consistent with this explanation as part-time jobs are exempt from such legislation.

From the employees' point of view, generous unemployment insurance (UI) benefits induce them to be more picky about taking jobs while remaining in the labor force. Primary benefits in most European countries are granted more easily than in the U.S. and last for a year or more, as against twenty-six weeks in the U.S. For these reasons, employment growth is likely to be lower and the unemployment rate higher in Europe than in the U.S.

However, European countries have had these liberal welfare provisions since the 1950s, and until the late 1970s have had consistently lower unemployment rates — rarely exceeding 2-3 percent — than the U.S. During that period, the prevailing consensus attributed the better employment performance in Europe to the same policies now blamed for its poorer performance. Unemployment insurance (UI) benefits were believed to help in stabilizing the level of demand during a downturn in output and employment. This view was shaped by the experience of the Great Depression during which the unemployment rate rose, by differing estimates, to between 20 and 25 percent, when UI was nonexistent. These facts suggest that it is necessary to look more carefully at the determinants of the unemployment rate.

Unemployment: inflows and duration

The unemployment rate measures the percentage of the labor force (employed plus unemployed) who, in any given survey period, report themselves as out of work and looking for a job, as well as workers on temporary layoff. For a labor force of 100, if 2 workers were to enter unemployment every month and remain unemployed for three months, the unemployment rate would be 6 percent per month. The same 6 percent rate would prevail if one worker were to enter unemployment every month and stay unemployed for six months. Under "steady

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state" conditions, the unemployment rate equals the inflow into unemployment, expressed as a percentage of the labor force, multiplied by the average duration of unemployment.

This breakdown of the unemployment rate helps explain why policies meant to protect workers from layoffs can end up raising the unemployment rate. Faced with such legislation, employers become more reluctant to hire new workers and the average duration of unemployment rises. From the workers' side, UI benefits allow those who are unemployed to search longer (or to wait longer, as the case may be) for a suitable job.

By itself, UI benefits can also raise inflows into unemployment by making employers more prone to lay off workers temporarily. The incentive for laid off workers to await recall, as opposed to search for and move to another job, rises with the extent of benefits. Without such benefits, a firm would be reluctant to resort to temporary layoffs because it might find a part of its experienced labor force working elsewhere when it needs them again. For this reason, the rate at which laid off workers are recalled by firms rises around the time UI benefits are exhausted.

In the U.S., this effect is mitigated by the system of taxation since taxes on employers for the UI fund are linked to their layoff record, and thereby provide an incentive to reduce layoffs. From the employees' point of view, UI does not have a significant impact on the inflows into unemployment because "job leavers," discharges, inexperienced workers, and labor force entrants are rarely eligible for benefits.

Eurosclerosis

In brief, UI benefits raise unemployment primarily by prolonging the duration of unemployment. This is the major difference behind the unemployment figures of the U.S. and European economies: the latter have a much higher duration of unemployment. From 1976-1986, the inflow into unemployment over *eight* weeks as a percentage of the labor force averaged 1.9 percent in the United Kingdom, whereas the corresponding average unemployment rate was 8.8 percent. For the U.S. the inflow over *five* weeks as a percentage of the labor force averaged 3.0 percent and the corresponding average unem-

ployment rate was 7.4 percent. The greater inflow over a shorter period of time despite a lower unemployment rate in the U.S. implies a much lower duration of unemployment.

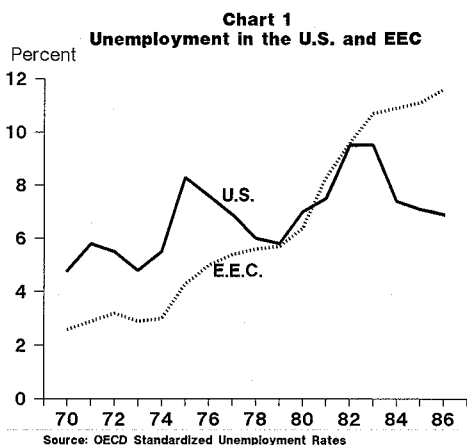
Furthermore, the rise in unemployment in the U.K. has come about almost entirely through a rise in duration. For males in the U.K., the monthly inflows over the periods 1962-1966, 1967-1975, and 1975-1983 averaged 1.5, 1.6, and 1.7 percent respectively; the corresponding average male unemployment rates over these periods were 2.4, 3.9, and 10.6 percent respectively. By contrast, the smaller rise in U.S. unemployment over these periods has come about through increases in both inflow and duration.

Prior to the 1970s, the European countries could sustain low unemployment rates in part because economic shocks were not very severe. Starting in the 1970s, oil price rises, increasing competition from Asian countries, and other structural shocks required fundamental adjustments. Firms could postpone, but not altogether avoid, layoffs. Unlike in the U.S., however, laid off workers have not been quickly absorbed into other lower paying sectors; nor have they returned to their original employers at much lower real wages, as evident in recent domestic wage contracts. Moreover, although replacement rates (the ratio of UI benefits to wages) have not changed much in recent years in Europe, the administration of UI benefits has become more lax.

Another factor that needs to be considered is that the percentage of the labor force that is unionized in most European countries is greater than that in the U.S. From 1965-1977, on average, 35 percent of all employees in the EEC countries were unionized, as against 28 percent in the U.S. Some economists have attributed the rise in European unemployment to excessively high real wages imposed by unions. Their argument is that the unemployed (outsiders) cannot compete directly with the employed workers (insiders) in bidding down wages. What this approach fails to explain is why the unemployed do not bid down wages in the nonunionized sector.

The Canadian connection

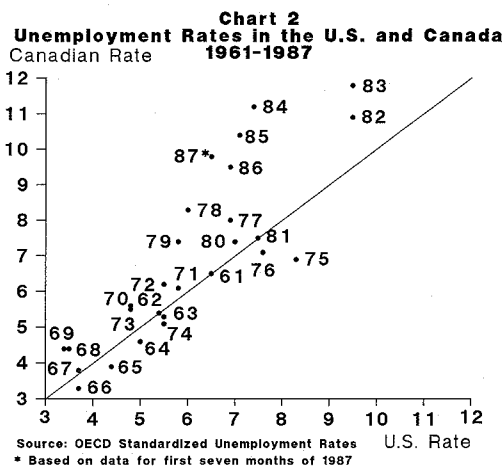
To assess the effect of labor market policies on the unemployment rate, a comparison of the



U.S. with Canada is instructive. Both the U.S. and Canada have identical methods of measuring unemployment, very closely correlated business cycles, and similar labor force participation trends. As can be seen in Chart 2, the Canadian unemployment rate hovered around the U.S. unemployment rate until the late 1970s. Although Canada's real GNP recovered after the 1982 recession at a rate consistent with the recovery in U.S. real GNP, its unemployment rate has remained higher. (By contrast, recent European unemployment can partly be attributed to contractionary fiscal and monetary policy that has kept their real GNP growth sluggish.)

Orley Ashenfelter and David Card have compared and analyzed various features of the U.S. and Canadian labor markets over the period 1966 to 1984. They found that effective minimum wages, the proportion of the work force covered by UI, and payroll taxes as a percentage of employee compensation have been roughly the same in both countries over that time period.

They then looked at three determinants of the generosity of the UI system: replacement rates, duration of benefits, and the fraction of the unemployed who are UI recipients. While the average duration of benefits has been about the same, the net (after-tax) replacement rate is currently lower in Canada. However, they found that, due to stricter eligibility criteria, the ratio of UI recipients to total unemployed was lower in the U.S. at an average of about 30 percent versus 90 percent in Canada over the period 1966-1984. Although they considered the difference to be "quite remarkable," they neverthe-



less concluded that it could not explain the recent divergence because it had existed for about twenty years.

The greater stringency with which benefits are now granted in the U.S. warrants more emphasis. Due to deliberate changes in economic policies from 1980 onwards, extended and supplemental UI benefits that were previously available beyond 26 weeks were drastically reduced. In 1975, when the total unemployment rate was 8.5 percent, 78 percent of the unemployed received some kind of benefit. In 1982, when the total unemployment rate was 9.7 percent, only 45 percent received some kind of UI benefits. Without the change in policy, more of the unemployed would have received benefits in 1982 because the fraction of unemployed workers eligible for UI rises, along with layoffs, in accordance with the severity of the recession.

Conclusion

The generous UI provisions of European economies seem to raise their unemployment rate by prolonging the duration of unemployment. Laws shielding workers from layoffs and dismissals contribute to lower inflows into unemployment in Europe, but also decrease the outflows by reducing new hires and recalls. As a result, they have hampered Europe's ability to adjust to the economic shocks of the 1970s. The recent persistence of unemployment in Canada compared to the U.S. supports this conclusion, as it can be traced to the much easier availability of UI benefits in Canada.

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Opinions expressed in this newsletter do not necessarily reflect the views of the management of the Federal Reserve Bank of San Francisco, or of the Board of Governors of the Federal Reserve System.

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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 10/14/87	Change from 10/7/87	Change from 10/15/86 Dollar	Percent ⁷
Loans, Leases and Investments ^{1 2}	207,075	- 1,522	2,540	1.2
Loans and Leases ^{1 6}	183,125	- 1,550	557	0.3
Commercial and Industrial	50,942	- 634	491	0.9
Real estate	71,621	- 49	4,842	7.2
Loans to Individuals	36,976	- 57	4,291	10.3
Leases	5,405	- 1	218	3.8
U.S. Treasury and Agency Securities ²	16,763	- 132	3,867	29.9
Other Securities ²	7,187	160	770	9.6
Total Deposits	209,212	2,119	2,599	1.2
Demand Deposits	54,649	2,330	2,903	5.0
Demand Deposits Adjusted ³	35,120	- 1,417	625	1.7
Other Transaction Balances ⁴	20,096	- 272	2,240	12.5
Total Non-Transaction Balances ⁶	134,467	61	1,936	1.4
Money Market Deposit Accounts—Total	44,091	- 287	2,783	5.9
Time Deposits in Amounts of \$100,000 or more	31,044	- 167	2,795	8.2
Other Liabilities for Borrowed Money ⁵	22,202	- 2,708	6,223	21.8
Two Week Averages of Daily Figures	Period ended 10/5/87	Period ended 9/21/87		
Reserve Position, All Reporting Banks				
Excess Reserves (+)/Deficiency (-)	0	27		
Borrowings	158	91		
Net free reserves (+)/Net borrowed(-)	- 157	- 63		

¹ Includes loss reserves, unearned income, excludes interbank loans

² Excludes trading account securities

³ Excludes U.S. government and depository institution deposits and cash items

⁴ ATS, NOW, Super NOW and savings accounts with telephone transfers

⁵ Includes borrowing via FRB, TT&L notes, Fed Funds, RPs and other sources

⁶ Includes items not shown separately

⁷ Annualized percent change