

Chapter 16 - The Indispensability of Full Employment¹

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1. Challenging the conventional wisdom about unemployment.

The public debate about the state of the economy often frames equality and employment as inherently in conflict. According to the current politically dominant view, the only reliable way to create more jobs is to increase inequality: the claim is that lowering wages for workers at the middle and the bottom will make it profitable for firms to hire more workers.

This brief essay leaves the important broader critique of the inequality-unemployment trade-off to others² and seeks, instead, to highlight a different causal connection between inequality and unemployment: *high unemployment increases inequality*.

The focus is on the experience of the United States, which, by most measures, has the highest levels of --and has seen the biggest increases in-- inequality among the world's rich countries. Despite frequent references in the 1990s to the "Great America Jobs Machine," the United States has operated below even conservative estimates of full employment for most of the last three decades. That is, unemployment has been unnecessarily high in the United States precisely during the period when economic disparities have been on the rise.

The contrast between the path of inequality when unemployment rates have been low (as they were in the boom of the late 1990s) and when they have been high (as they have been during and since the Great Recession) suggests a strong link between high unemployment and increasing economic inequality. The strong macroeconomic performance of the late 1990s stands out, in particular, as a period with much to teach us today as the world economy continues to struggle from the lasting effects of the Great Recession.

To make the case for the importance of full employment, I will first demonstrate just how consistently the United States has strayed in recent decades from maximizing its output. I will then contrast the behavior of several indicators of inequality across two distinct periods -- the boom of the late 1990s (1996-2000) and the bust of the late 2000s (2007-2009). Finally, I will draw some lessons about macroeconomic policy based on the experience of the second half of the 1990s.

2. Far From Full Employment

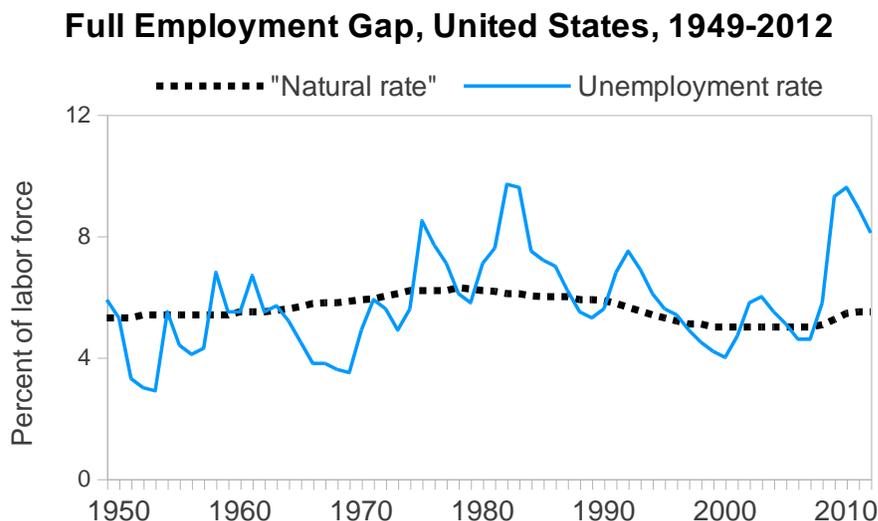
Since the end of the 1970s, the US economy has consistently failed to reach even fairly conservative estimates of full employment. Figure 1 shows the Congressional Budget Office's calculation of the "natural rate" (also sometimes referred to by the closely associated term "non-accelerating inflation rate of unemployment" or NAIRU) along with the official unemployment rate for the period 1949 - 2012. From 1949 through 1978, a period when economic inequality in the United States fell by most measures, the unemployment rate was at or below the CBO's natural rate in 21 of 30 years. During these same years, when the unemployment rate was above the natural rate, the difference tended to be small and short-lived. By contrast, from 1979

¹I thank Dean Baker, Jared Bernstein, Tom Palley, and participants at the February and March 2013 conferences on "A Trans-Atlantic Agenda for Shared Prosperity," sponsored by the AFL-CIO, the Friedrich Ebert Foundation, and IMK, for many helpful comments and discussions.

²For a critical summary of the debate, see David Howell (ed.), *Fighting Unemployment: The Limits of Free Market Orthodoxy*, Oxford University Press, 2004.

through 2012, the unemployment rate was above the full employment rate in 23 of the 34 years. Furthermore, in bad times the unemployment rate was much farther above the natural rate than the unemployment rate was below the natural rate in good times. In fact, if we weight the years above and below the natural rate by how many percentage points the actual unemployment rate diverged from the natural rate, between 1979 and 2012, the US economy experienced 36.1 unemployment-years when unemployment was above the natural rate, compared to only 5.4 years when unemployment was below the natural rate.

Figure 1



Source: Analysis of CBO, BLS data.

3. Inequality in booms and busts

Economists, sociologists, and social psychologists have documented the enormous costs of unemployment, whether measured in terms of lost economic output, the impact on disadvantaged communities, or physical and mental health.³ However, academic and policy debates have underplayed the role that high unemployment has played in increasing inequality. While a comprehensive review of this connection is beyond the scope of this chapter, a few examples from recent economic history illustrate the size and strength of the connection between unemployment and inequality.⁴

To make the point as simply as possible, let's compare how indicators of inequality behaved in two recent periods: the first, during the economic boom from 1995 through 2000, and the second, the recession and weak recovery from 2007 through 2010. In these boom years, unemployment averaged 4.6 percent, compared to 8.2 percent in the later bust. In the upswing, the unemployment rate fell 1.6 percentage points and employment rates increased 1.5 percentage points; in the downturn, unemployment soared 5.0 percentage points and

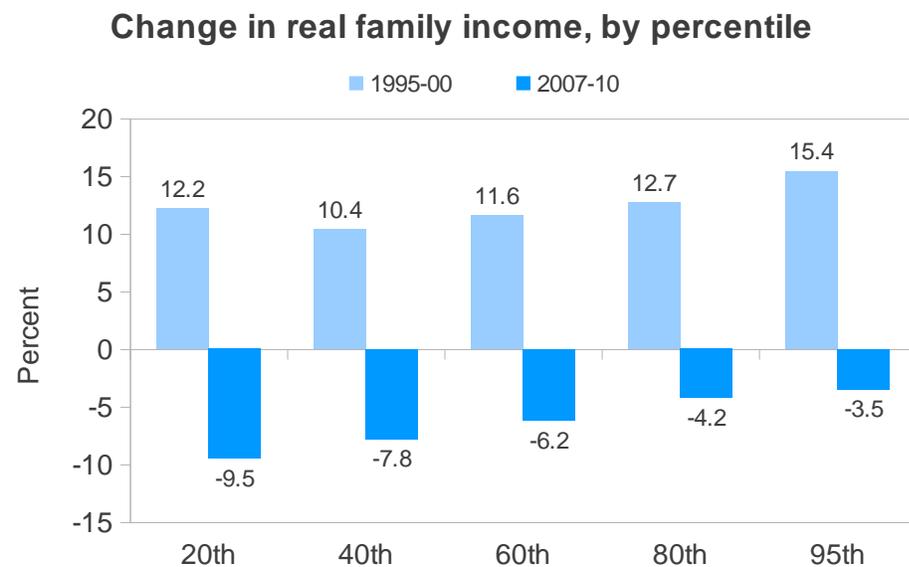
3. For recent reviews of the private and public costs of unemployment, see Lauren Appelbaum (ed.), *Reconnecting to Work: Policies to Mitigate Long-Term Unemployment and Its Consequences*, Kalamazoo, Michigan: W.E. Upjohn Institute, 2012, and, Till von Wachter, Testimony before the Joint Economic Committee of U.S. Congress on "Long-Term Unemployment: Causes, Consequences and Solutions," April 29, 2010, http://www.columbia.edu/~vw2112/testimony_JEC_vonWachter_29April2010.pdf.

4. For a thorough discussion of these issues, see Dean Baker and Jared Bernstein, *Getting Back to Full Employment: A Better Bargain for Working People*, Washington, DC: Center for Economic and Policy Research, 2013, available at <http://deanbaker.net/books/getting-back-to-full-employment.htm>.

employment dropped 4.5 percentage points.

The impact of unemployment on inequality is immediately obvious in Figure 2. In the low-unemployment years of the late 1990s, real family incomes grew faster at the bottom (the 20th percentile) than at the middle (the 40th and 60th percentiles) and almost as fast as the upper middle (80th percentile). Incomes did grow even faster near the top (95th percentile), but the contrast with the bust is striking. In the aftermath of the Great Recession, incomes fell at all levels, but most at the bottom, less in the middle, and least at the top. The low unemployment of the late 1990s was good for families at the bottom --and almost equalizing. The high unemployment of the late 2000s was bad for families across the board, but especially bad for those at the middle and the bottom, who fell even farther behind.

Figure 2.

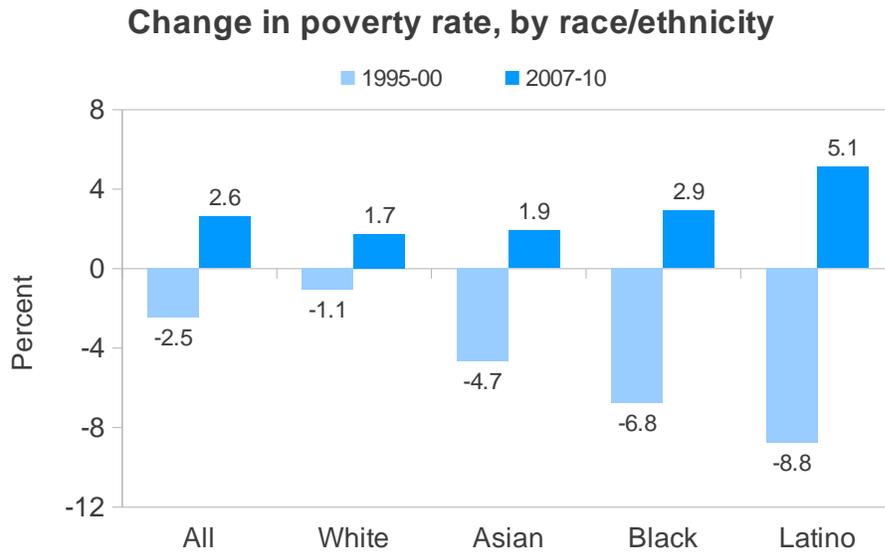


Source: Analysis of Census data.

A similar pattern holds for poverty rates by race in Figure 3. In the 1990s boom, poverty rates plummeted for racial minorities: down 4.7 percentage points for Asian Americans, 6.8 percentage points for African Americans, and 8.8 percentage points for Latinos, compared to a much smaller 1.1 percentage-point drop for whites. In the current bust, poverty rates rose least for whites (up 1.7 percentage points), more for Asian Americans (up 1.9 percentage points), and most more for blacks (up 2.9 percentage points) and Latinos (up 5.1 percentage points).

Part of these differences across booms and busts reflects the greater availability of work in upswings than in downturns. But part of the differences also reflects the increased bargaining power for workers at the middle and the bottom. When the unemployment rate remains low for a prolonged period, employers find it harder and harder to recruit and retain workers to meet high levels of demand for the goods and services they produce (when the unemployment rate is low, aggregate demand in the economy tends to be high). Under those circumstances, workers can ask for higher wages, better benefits, more flexible schedules, and other improvements in working conditions, and employers have little choice but to accede if they want to meet customer demand.

Figure 3.



Source: Analysis of Census data.

High unemployment has the opposite effect. Employers have little trouble finding and retaining workers, so workers reduce their demands regarding wages and working conditions. Over most of the last three decades, excessive unemployment rates have reinforced the pervasive decline in bargaining power set in motion by a host of other changes in economic policy. These other politically driven policy changes include the erosion of the inflation-adjusted value of the minimum wage, the fall in unionization rates in the private sector, the deregulation of many well-paying industries, the privatization of many state and local government jobs, the passage of pro-corporate trade deals, the creation and maintenance of highly dysfunctional immigration system, and other, related institutional changes that had as their primary effect the reduction of the bargaining power of workers at the middle and bottom of the wage distribution.⁵

4. Macroeconomic Policy Lessons

Before and even into the early part of the 1995-2000 boom, the consensus of the economic profession in the United States was that the natural rate of unemployment was between 6.0 and 6.5 percent. Even many economists now widely known for the left-of-center views, including Paul Krugman, subscribed to this view.⁶ One obvious lesson of the late 1990s boom was clearly that economists' methods for estimating full employment were too conservative.

But, the potential lessons go deeper. The widespread belief in the 1980s and 1990s was that macroeconomic policy --which primarily uses fiscal and monetary policy to influence the

5. On factors undermining the bargaining power of U.S. workers, see, among others: Lawrence Mishel, Jared Bernstein, and Heidi Shierholz, *The State of Working America 2008/2009*, Ithaca, New York: Cornell University Press, 2009, and subsequent updates at <http://www.stateofworkingamerica.org>; Dean Baker, *The United States Since 1980*, Cambridge University Press, 2007; and John Schmitt, "Inequality as Policy," Center for Economic and Policy Research Issue Brief, 2009, <http://www.cepr.net/documents/publications/inequality-policy-2009-10.pdf>.
6 See, for example, Paul Krugman, "How Fast Can the U.S. Economy Grow?" *Harvard Business Review*, July 1997, <http://hbr.org/1997/07/how-fast-can-the-us-economy-grow/ar/1>.

demand side of the economy-- could do little to lower unemployment. That is because economists and policymakers believed that unemployment was primarily due to supply-side factors such as powerful unions, high minimum wages, generous unemployment insurance benefits, and other "labor-market rigidities". As a result, governments in the United States --and especially in Europe-- used macroeconomic policy sparingly or not at all in their efforts to increase employment. In Europe, macroeconomic policy, especially monetary policy connected with the creation of the single currency, arguably often worked actively against lowering unemployment.

The boom of the late 1990s was, instead, fueled by a stock-market bubble. As the boom got underway, the Federal Reserve Board made a decision not to counteract the expansionary effects of mounting stock-market wealth until there were clear signs that the increase in demand was causing the economy to overheat and leading inflation to rise. Despite the beliefs of most economists at the time, prices did not take off. In fact, inflation moved little, even by the time that the tech bubble burst in 2000-2001. Rising demand led to lower and lower unemployment - -eventually hovering near 4.0 percent-- but without any significant rise inflation. This experiment proved that supply-side factors were not the cause of unemployment.

The problem with bubble-fueled growth was not that it produced inflation --it did not. Instead, the problem was that the resulting growth was not sustainable, and worse, it left the economy with a hangover that slowed employment growth in the subsequent recovery.⁷ Seen in this light, the tech bubble of the late 1990s strongly supports the feasibility of --and the broad scope for-- expansionary macroeconomic policy.

When unemployment is high, economic policymakers would do well, at the very least, to follow the example of the Federal Reserve Board from the late 1990s: enact expansionary policies until there are signs that inflation is accelerating at an unacceptable rate. The tech boom inadvertently demonstrated that economic estimates of full employment were too conservative. Given the high social cost of unemployment, including the impact on inequality, a strong case exists for using macroeconomic policy to test empirically for the point where --in practice, not in theory-- the economy reaches full employment.

Expansionary monetary and fiscal policy are much better tools for reaching and maintaining full employment than the asset bubbles of the 1990s and 2000s. First, while there are real challenges, fine-tuning monetary and fiscal policy is much easier than trying to control asset bubbles. Second, policymakers have a much easier time combating a policy-induced acceleration in inflation (quick increases in interest rates, for example), than they do cleaning up after a burst asset bubble (as the current anemic recovery demonstrates with great clarity).

5. Conclusion

High unemployment is a social scourge, but the damage is not limited to those who lose their jobs. The needlessly high unemployment maintained during most of the last three decades have reduced the bargaining power of all workers, including those who manage to avoid being laid off. The experience of the late 1990s, when sustained low unemployment spurred broad and rapid wage growth for the only period in the last three decades, illustrates the central role that full employment should play in any plan to attack high and rising inequality.

7. In many respects the 2001 recession and recovery were a dry-run for the much more severe recession of 2007-2009 with its even more sluggish recovery.