

Cato Institute Policy Analysis No. 4: Unemployment: Causes and Cures

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Executive Summary

At the end of 1980, 7.4 percent of the U. S. civilian labor force, about 7.8 million potential workers, was unemployed. Eight-hundred thousand of these had quit their last jobs, 4.2 million were laid off or discharged, and the remaining 2.7 million were new or returning participants in the labor force who had not yet found jobs. (1) About a million more persons were interested in and available for work but were not seeking jobs actively enough to be counted among the labor force. (2)

Because the percentage of those in the labor force with jobs is well below "full employment" levels (3), and because wages and salaries are the primary source of income for most Americans, unemployment deserves a high priority position on the policy maker's agenda.

Policies affecting unemployment are not limited to those directed at unemployment. Indeed, perhaps the major contribution economists can make to public policy discussion is an explanation of the indirect and less obvious effects on unemployment of various policies. Economists can also demonstrate the trade-offs inherent in policy options, emphasizing that the achievement of one goal will often frustrate the achievement of another. These trade-offs reflect the inescapable economic fact that we can't have our cake and eat it too, or as economists are fond of saying, "There is no such thing as a free lunch."

The purpose of the discussion below is to point out the overall effects and inherent trade-offs of policies affecting unemployment. Knowledge of the effects and trade-offs of policies makes possible reasoned discussion and choices among various policy options.

Because a healthy economy providing jobs for all who want to work is the best unemployment antidote, the discussion begins with an analysis of economic growth. Other unemployment policies can be best studied by examining incentives -- those of employers to provide jobs and those of potential employees to look for jobs. Finally, it is important to study the overall effects of policies designed specifically to reduce unemployment.

Economic Growth

Other things being equal, the greater the amount of goods and services produced, the greater the labor required for production. Because economic growth and employment go hand in hand, regulation and taxation that discourage the operation of business will also reduce the demand for labor. Many entrepreneurs are faced with regulations that force allocation of resources away from production. For example, rather than purchasing raw materials needed for final production, managers must instead purchase equipment mandated by OSHA or EPA. Or, rather than using clerks to expedite sales, they must use clerks to fill out forms required by the government. Furthermore, if an entrepreneur can

turn a profit even in the face of costly regulations, high income tax rates will reduce his ultimate financial reward, and risk-taking business ventures thus become less attractive.

Regulations and taxes may have an especially strong impact on smaller businesses, since they have less access to capital markets than larger enterprises. When fewer small businesses are started and when larger firms curtail expansion, jobs that otherwise might be created never come to be.

Regulations sometimes overlooked in their impact on unemployment are those dealing with occupational licensing. If individuals cannot use their cars as cabs, sell homemade sandwiches on street corners, or move furniture without the appropriate licenses, then their job opportunities are limited. Licensing boards are typically controlled by practitioners in the relevant occupations, and these practitioners often use their licensing powers to restrict the number of entrants to their occupations. The reduced supply of practitioners keeps wages -- and thus the prices of goods and services provided -- high. An overall assessment of licensing will consider the screening services provided by the boards (for example, assurances that licensed furniture movers are experienced and competent -- or at least more so than those without licenses) and the increased cost of licensed goods and services as well as the inhibiting effects of licensing on employment.

Recognizing the potentially stifling effect of regulation and taxes, some have proposed that so-called enterprise zones be established in high unemployment areas. Businesses would be exempt from certain taxes and regulations within these zones and would thus be encouraged to set up shop and employ local labor. Several policy decisions are necessary here: the location of the zones, the specific taxes and regulations from which the business would be exempt, and the duration of the exemptions. In general, the less "free" the zones, the fewer the jobs that will be created within them.

An overall policy assessment of enterprise zones requires consideration of both the jobs that would be created and the effects of reducing regulation and taxes. Proponents of regulations will argue that some goals such as clean air are worth fewer jobs, and decision makers will differ on the values they place on these goals. The trade-off inherent in tax reductions in this and other policy options is the decreased Treasury revenue and reduction of funds for government programs, the perceived value of which will also vary among decision makers. With regard to tax reductions, it is worth noting the point raised by supply-side adherents: If some tax rates are reduced, the percentage increase in that which is taxed (e.g., income, profits, sales) may be greater than the percentage decrease in tax rates, so that overall tax receipts will actually increase. For example, lower taxes on profits may encourage business activity, and the resultant increase in profits may exceed the decrease in the profit tax rate, leading to an overall increase in profit tax receipts. The effect of reduced tax rates on the level of that which is taxed and tax receipts is an empirical question, however, whose answer will vary from one context to another.

Monetary and fiscal policies designed to increase economic growth also affect inflation. Although a detailed analysis of these policies is a topic that deserves separate study, it is worth putting to rest here (if the experience of the last few years has not already done so) the idea that increased inflation reduces unemployment.

This idea is based in part on the Phillips curve, the negative relationship observed over time between inflation and unemployment. Correlation does not imply causality, however, and in the same way that the positive association between height and weight among individuals does not mean that people can become taller by eating more, it does not follow from the Phillips curve that increasing the inflation rate is an anti-unemployment policy.

Many economists believe that increased inflation can reduce unemployment only when the inflation rate is better perceived by employers than workers. With this assumption, a worker will quickly accept an employer's offer of an inflated wage that, although normal in dollars of constant purchasing power, seems high to that worker. When workers accept wage offers more quickly, the length of unemployment per worker falls, and the unemployment rate is reduced.

This reduction in unemployment cannot occur unless workers systematically underestimate the inflation rate. When workers are aware of the inflation rate and, for example, have their pay adjusted according to the cost of living, they will interpret wages properly and not be misled into thinking that a normal wage offer is a relatively high wage offer.

Rather than merely failing to decrease unemployment, inflation may actually increase the unemployment rate. Frequent

concomitants of inflation, such as high interest rates and volatility and uncertainty in the financial and product markets, increase the risks inherent in business operations and thereby discourage the expansion of firms and the creation of jobs.

Monetary and fiscal policies do not affect the economy uniformly, but rather have greater impact in some sectors than others. The resultant effect on relative prices and wages across sectors have not been studied as thoroughly as effects on the overall level of prices and wages. Nevertheless, some economists would emphasize that the distortion of the relative price structure has further adverse effects on business and the number of jobs by causing the market system to operate less efficiently.

Further market distortion is caused by government intervention in specific industries, such as price controls on oil and natural gas. Distorted prices do not reflect the scarcity values of goods and services, and lead to inefficient allocations of resources. For example, the controlled price of natural gas understates its true value, encouraging the over consumption of natural gas and underutilization of its substitutes.

Employer Incentives

Employers will hire workers if the revenue resulting from the workers' labor exceeds the costs of hiring and employing that labor. These costs are not limited to wages and salaries plus fringe benefits; they include contributions to programs such as social security and unemployment insurance as well as the costs of employee selection and training. A reduction in employer-mandated social security and unemployment insurance contributions per worker clearly would encourage employment and thus is a possible anti-unemployment policy. Because reductions in these contributions would lower program funding, the trade-off between two policy goals (expanded employment opportunities and Treasury revenue adequate to fund existing programs) is clear, and again the policy maker's assessment of the value of such programs is important.

Work-sharing programs, in which more workers are employed and hours per worker are reduced, tend to increase employer costs because of the selection and training costs incurred for new employees and because the employer is not free to choose the number of workers and hours per worker that minimize costs. Rather than simply redistributing income from old to new workers, the increased costs and decreased profits accompanying work-sharing induce employers to raise prices and/or curtail production. Increased prices discourage consumer demand and, like reduced production, lead to decreased demand for labor, an effect contrary to that intended by advocates of work-sharing.

Perhaps the most clear-cut example of a law raising employers' costs is the minimum wage. (4) Increases in the minimum wage in some cases are absorbed by employers to their employees' benefit. In other cases, the minimum wage forces labor costs above the revenue that a minimum wage worker's employer could earn. The result is that workers who might have been hired at lower wages are priced out of the market at the minimum wage level. Rather than hiring these workers, employers can automate, use more skilled labor, produce in foreign countries, or simply produce less. A general inefficiency obtains because the minimum wage precludes lower-cost production. The extent to which increased costs are reflected in higher prices or lower output depends on the purchasers' reactions to higher product prices, i.e., the employer's ability to "pass through" costs.

The job-reducing effect of the minimum wage is not always obvious because the jobs low-wage workers might have obtained if it were profitable to employ them do not always exist. Sometimes we notice that stores using teenagers for deliveries cancel their delivery services after the minimum wage is increased. Less obvious is the lack of delivery service that never existed. Also, a given minimum wage level has its greatest impact in low-wage markets, in which relatively many jobs might be offered at pay levels below the minimum. Consequently, faced with a national minimum wage law, industries not relocating in foreign countries without minimum wages may choose to locate in high-wage areas where higher product prices allow profitable employment of workers at minimum wage levels.

In addition to its direct effect on employment, the existence of the minimum wage may increase employers' selection and training costs. In the case of selection costs, minimum wage level jobs may attract many applicants for a single job opening. An employer cannot offer lower wages to those who would be willing to work for less but instead must screen applicants using other selection criteria, including personal friendship, race, or other factors irrelevant to work performance. Furthermore, an employer cannot distinguish between inexperienced applicants who had no desire to

work and those whose past search for jobs was unsuccessful because of the minimum wage. Employee selection may be resolved by incurring further costs of interviewing or testing or simply by favoring those with prior job experience. The last solution favors those who obtained prior job experience as a result of connections with family or friends. Some economists have blamed the very high unemployment rates for black teenagers on the minimum wage: Not only does the minimum wage price many of these workers out of the market, but the selection criteria used by employers may particularly adversely affect young blacks with little job experience.

On-the-job training may be another victim of minimum wage laws. Training young workers while paying them low apprenticeship wages may become impossible because of the mandated minimum. The result is a decrease in on-the-job training and another labor market advantage for those able to obtain training through formal courses or family and friends.

Because of the relatively high unemployment rates for teenagers and young adults, a sub-minimum wage for young people has been proposed as an intermediate policy option between raising the minimum periodically and the alternatives of revoking it or letting inflation steadily erode its value. Discussions have often focused on the employment-generating effects of the sub-minimum wage versus employers' incentives to hire lower-wage young people instead of older workers. Complicating a regulation, in this case adding sub-minimum wage provisions to the minimum wage law, therefore involves additional trade-offs -- between employment opportunities for older and younger workers.

Much of the analysis of the minimum wage can be applied to other wage floors, such as the Davis-Bacon Act's wage rates for federally funded construction, union-management collective bargaining agreements, or government pay levels exceeding what workers could command in the private sector. (5) In general, higher wages in the absence of offsetting productivity increases lead to higher product prices, reduced quantity demanded by consumers, and, ultimately, less demand for workers to produce. These wage levels may also lead to unrealistic pay expectations for workers generally, and these workers' reluctance to take jobs in other sectors may increase their duration of unemployment.

The adverse effects of wage floors are a strong point in favor of their elimination. However, it does not follow that forcing wages lower generally is a good idea. Apart from the political assessment of government intervention into the labor market in general and collective bargaining agreements in particular are the economic effects of wage ceilings, such as those proposed as part of price control or guidelines programs. Employers may not be able to attract the workers they need at the ceiling levels and must choose between violating the law, rearranging production in a less efficient manner, or using accountants and lawyers to help circumvent the spirit of the wage ceilings while obeying their letter. The effects of wage ceilings are much like those of price ceilings -- reduced supply of labor or products at the mandated levels, subsequent shortages, and wasteful use of resources in attempting to circumvent the ceilings. In general, like wage or price floors, the induced distortions of wage or price ceilings lead to inefficient allocations of resources and a less smoothly operating economy.

Programs designed to reduce the cost of workers to employers, such as targeted and new jobs tax credits, also will reduce employer costs and thereby encourage employment. Of course, these programs involve a reduction of Treasury revenues directly in forgoing the revenue and indirectly in establishing the administration of the program. Furthermore, like the sub-minimum wage, the subsidies may encourage employers to favor certain classes of potential employees over others.

Employee Incentives

Individuals will be more interested in working as their take-home pay increases and their income from other sources decreases. Accordingly, the incentive for people to work will be increased if their income taxes and social security contributions are reduced. Again, a trade-off between employment and Treasury revenue exists in this policy decision, although, as noted above, supply-siders have

argued that the reduction in tax rates will engender a higher offsetting increase in output and employment, so that Treasury revenue will actually increase.

In addition to increasing take-home pay by reducing taxes, the government could attempt to increase the gross pay to

workers by increasing the minimum wage. Unfortunately, rather than increasing the pay for a given job, mandated wage floors such as the minimum wage may simply cause certain jobs to disappear, or indeed, never come into existence.

Income sources that are reduced when people work, such as unemployment compensation and welfare, affect work incentives. Many of these programs have implicit tax rates in that their payments are reduced as labor earnings increase, so that the overall increase in income resulting from work is less than earnings, being reduced by the decrease or total loss of program support. These implicit tax rates, like those of the explicit income tax, can discourage work. Accordingly, the following trade-offs present themselves in unemployment insurance, welfare, and other transfer program policy options: (1) cutting program payments, thus encouraging people to look for jobs, but also reducing income to those who fail to find jobs, and (2) granting income to eligible persons independently of their work experience, thus removing the disincentive effect of the programs on work effort (although also possibly supporting people who don't need the income). A sample "independent payment" program would be to give a lump-sum unemployment insurance payment to a person when he becomes unemployed rather than paying him an amount for each week of unemployment. Under this arrangement, there is no incentive for an individual to remain unemployed, since he receives no additional payments to compensate for lengthy unemployment. However, because an individual would receive the same amount if the duration of his unemployment were brief or lengthy, individuals with short periods of unemployment might be "over-subsidized "

Employment and Training Programs

Government programs to provide jobs and train workers have been used widely in the United States since the 1960s. Two of the largest programs, forerunners of the present CETA programs, were the Neighborhood Youth Corps, providing job experience, training, counseling, and education to high school drop-outs, and the Manpower Development and Training Act, training unemployed workers on the job and within the classroom. Whether these programs were successful or not depends in part on the increased earnings participants received as a result of their programs, a question that economists have not yet answered decisively. (6) Other criteria by which these programs might be judged are given less attention in the empirical economics literature. These include the alternative uses for the resources allocated to government training programs and the number of jobs that would have been created with alternative allocations of resources.

Using the federal government as an "employer of last resort" is another method of reducing unemployment. In addition to the taxpayer costs of this program, it is important to note that the nominal number of jobs created by the federal government may severely overstate the economy-wide net employment gains. Federal grants to state and local governments may fund already existing jobs and merely shift the financing burden from state and local to federal taxpayers. Public employment jobs may also discourage workers from applying for private sector work where they may be sorely needed. Many goods and services may go unproduced because taxes -- and therefore labor and capital -- would be allocated away from the private sector (a good example of a program cost that is not obvious to many observers). The attempt to time public employment to coincide with high-unemployment periods can be frustrated not only by the difficulty of predicting the economy's performance but also by the time lags involved in assessing the economic situation, implementing the program, and waiting for the effects of the program to appear. Finally, policy makers should bear in mind the difference between efficient use of labor and reducing the Bureau of Labor Statistics' measured unemployment rate. If all unemployed individuals were assigned to unproductive jobs, thus lowering measured unemployment, would anyone be better off? If so, why not simply define recipients of unemployment insurance and welfare payments as "employed"? (7)

Another policy option, applicable to industries affected by foreign competition, is to use tariffs or quotas to exclude imports, thus increasing the demand for domestic products and the employment of American workers. Although this policy may save certain jobs, it restricts consumers in their choice of foreign goods and allows them to purchase only domestic products, which may be more costly. At the same time, a policy of protecting domestic industries by tariffs or quotas on foreign products will tend to reward inefficiency and discourage productivity, lowering the overall level of economic growth. The combination of lower productivity and higher prices tends to reduce real wages, another important dimension of the overall standard of living. Foreign countries' retaliatory quotas or tariffs compound these problems.

Conclusion

This discussion of economic growth, basic employer and employee incentives, and policies designed specifically to combat unemployment indicates that there is an extensive program of anti-unemployment policies, each with manifold effects. Although individual policy makers will differ on the value they place on the goals that can be achieved under various policy options, they should be aware of the trade-offs inherent in possible policy decisions. Of particular interest are the employment consequences of policies not generally considered to affect unemployment. For example, occupational licensing is viewed by many as a policy of consumer protection, yet it can reduce employment opportunities by inhibiting individuals and firms from entering licensed markets. Also, the minimum wage, by appearing to guarantee a certain level of earnings, is often thought to be an anti-poverty program. Unfortunately, by reducing employment opportunities, the minimum wage may promote poverty. Examining the overall effects of policies emphasizes the point that a policy should be judged by what it actually accomplishes rather than by what its proponents intend or hope it will accomplish.

An implicit assumption in this discussion is that unemployment is an undesirable feature of the economy that policy makers should seek to eliminate. It is important to keep in mind that some unemployment can be productive. The economy works most smoothly not when workers take any job, but rather when jobs and workers are well matched. Increasing the duration of unemployment and searching longer for work will allow individuals to find jobs for which they are best-suited. Quits and fires also can be viewed as productive by severing mismatches between jobs and workers. Finally, new entrants and reentrants to the labor force need time to adjust to a new or at least somewhat unfamiliar labor market. Recognizing these points, economists do not define "full employment" as literal total employment of the labor force. (1) (2)

FOOTNOTES

(1) U.S. Department of Labor, Bureau of Labor Statistics Employment and Earnings, Vol. 28, No. 4, April 1981.

(2) Ibid. These individuals are referred to as "discouraged workers," sometimes as the "hidden unemployed." They are not seeking jobs actively because they believe that job opportunities are not available.

(3) The "full employment" level of unemployment is thought to be about 5 percent at present. It is defined as the rate of unemployment that would exist if there were no job shortages and people were unemployed only because (1) they were moving from one job to another after quitting or being laid off, or (2) they were searching for a new job after entering or reentering the labor market.

(4) The federal minimum wage is now \$3.35 per hour; some state and local governments have higher minimum wages.

(5) Many wage agreements have cost-of-living indexes based on the Consumer Price Index (CPI). The CPI tends to overstate inflation when mortgage rates are increasing. Consequently, when applied to "wage floors," the CPI will tend to push these "floors" even further away from market levels.

(6) Long-term post-program earnings are necessary to assess the impact of these programs. For example, earnings in the year immediately after training may reflect some individuals' being placed temporarily in unusually attractive jobs and others choosing jobs with further training and therefore relatively low present but high future earnings.

(7) The definition of "the unemployed" varies greatly across countries, and one should not assume that one country has less idle labor than another simply because its reported unemployment rate is lower. An unanswered question in the United States is the number of people working in the "underground economy," not reporting income and not being counted among the employed.