Chapter 2

JOB LOSS: CAUSES, CONSEQUENCES, AND POLICY RESPONSES

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Today, I want to talk to you about job loss and the problems faced by displaced workers. As arbitrators, I am sure you are well aware of the pressures that may lead to the elimination of jobs as well as the consequences of job displacement for firms and workers. In addition, the factors underlying the rate of job displacement and the ability of workers to find new jobs have macroeconomic implications that affect the Federal Reserve's monetary policy decisions. So it is important to think carefully about how job displacement affects the economy and about the policies that have been proposed to help displaced workers. And it is helpful to hear a diverse range of views on the subject.

Indeed, my talk today will be drawing heavily from research that we have done at the Chicago Fed and what we learned at a conference that we held last fall called "Job Loss: Causes, Consequences, and Policy Responses." The conference brought leading academics together with business, labor, and community leaders to discuss this important topic.

First, let me say a little about the current state of the macro economy and why job displacement is important for monetary policy. Over the past two years, the economy has improved significantly. Real GDP—the broadest measure of output in the economy—has grown at an average annual rate of 4.3 percent. Recently, labor market conditions have improved as well: since April 2004, the unemployment rate has fallen from 5.5 percent to 5.2 percent. Over this same period, the economy added about 2.2 million jobs, and employment finally surpassed its prerecession peak in January.

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As you know, the Federal Reserve aggressively reduced short-term interest rates starting in 2001 and has now maintained an accommodative monetary policy for an extended period. Looking forward, our best assessment is that the economy continues to be on a solid growth path. Despite the rise in energy prices, underlying inflation remains low, and longer-term inflation expectations are well contained. Accordingly, we believe that we can continue to remove monetary policy accommodation at a measured pace. But if inflation prospects worsen, we will act as necessary to fulfill our obligation to maintain price stability.

Of course, before this improvement in the economy, we suffered a recession. The downturn was relatively mild. However, throughout this last business cycle, rates of job displacement were relatively high—as high as in some periods when the unemployment rate was much higher. By "job displacement" or "job loss," I mean workers who had held their jobs for a substantial period of time but lost them through changes beyond their control—such as technological change leading to a plant closing or a reduction in force. The fact that job loss rates have been high, even though unemployment has been relatively low, suggests that the pace of change in the economy has increased. It also means that a larger-than-normal fraction of the unemployed face difficult challenges in finding new employment.

This increased rate at which experienced workers have been losing long-held jobs is one of the factors that monetary policymakers have to consider in judging the extent of inflationary pressures currently facing the economy. This judgment is complicated because an increase in job displacement could have two opposing effects on the labor market. On the one hand, with more unemployed workers likely facing difficult job transitions, there could be somewhat less slack in the economy than the current unemployment rate would ordinarily suggest. And with more of the unemployed lacking the needed skills to fill available jobs, there could be more shortages of certain kinds of workers, leading to upward pressure on labor costs. On the other hand, an environment in which job displacement is more common may make workers reluctant to press for large wage increases, which would tend to restrain labor cost pressures. What all of this means for monetary policy is that we need to keep an eye out for changes in the relationship between labor costs and resource slack in labor markets. So far, at least, wage pressures have not been higher than one would expect on the basis of the usual measures of labor market slackness.

Well before I started thinking about the topic from the point of view of monetary policy, I worked on job displacement issues as Under Secretary of Labor 30 years ago and as a Deputy U.S. Trade Representative in the early 1990s. To me, the fact that I have been involved with these topics for so long highlights their persistence and complexity.

In the United States, we enjoy greater productivity, lower prices, and a higher overall standard of living thanks to our openness to competition and international trade. In our economy, firms can boost their profits by finding newer, more efficient ways to produce. Other firms either adopt these better technologies or are forced out of business. By allowing competitive forces to operate, we ensure that our goods and services are produced by the lowest cost means, which translates into lower prices for consumers. In addition, by remaining open to international competition we reap the benefits of efficient production wherever in the world it takes place.

The adoption of new technologies and the "creative destruction" of lagging businesses are important factors in increasing productivity—that is, how much output our labor force can produce in an hour's worth of work. And, in the long run, increases in productivity historically have translated about one for one into gains in real hourly wages and benefits—and thus into improvements in our standard of living.

However, while most of us benefit when firms make changes in response to technological progress and competition, some people pay a significant price as the economy adjusts to these changes. Perhaps the largest costs are borne by the workers who have their careers upended. From 2001 to 2003, more than 5 million workers lost a job that they had held for 3 years or longer. Most of these workers lost their jobs through no fault of their own. For many, the arrival of a new technology simply rendered their jobs unnecessary.

Even at the Federal Reserve, we are not immune from the effects of technological improvements. Twenty years ago, the Chicago Fed had nearly 3,000 employees; today, we have fewer than 1,600. Much of the recent reduction was in staff working to process paper checks. This has been the result of the shift from paper checks to new electronic payment technologies. As a society, we all gain from the convenience of these new payment methods, which are quicker and more efficient. However, the workers who were doing a good job processing checks have to find a new career. This is a difficult transition for the Federal Reserve, and I know it is very painful for those most directly affected.

The Chicago Fed experience is just a small example of how technology has affected many parts of the economy. Over the past decade, we have seen enhanced competition and large improvements in technology lead to much faster growth in productivity. This has been great news for the economy overall. When productivity grows at a faster rate, the economy can grow faster—resulting in higher incomes and producing more goods and services for all of us to enjoy—without generating inflationary pressures. This ultimately makes our job at the Federal Reserve easier, because our mandate is to set monetary policy to support maximum sustainable economic growth and price stability.

Of course, in a dynamic economy, where technology is changing and markets are increasingly open to competition, some existing jobs will lose their value and thus disappear. This clearly causes disruptions to many lives. We need to pay special attention to the workers affected by such change, because it is this dynamic process that helps generate ever higher standards of living. We need policies to address their job loss, and we need to regularly rethink our policies as different industries and different types of workers are affected by change.

What can we do to help the workers who lose their jobs due to the very changes we seek to encourage? As we learned at our recent conference, this is a difficult task, one without easy answers.

One topic addressed by the conference was the changing characteristics of workers who are displaced. A more diverse group of workers is now experiencing job displacement. There have been striking increases in the fraction of displaced workers who are female, well-educated, white collar, and who were displaced from the service sector. This has happened in part because technological change and competition—both foreign and domestic—are affecting a broader group of workers.

Another topic discussed was the cost of job loss for displaced workers. Many displaced workers have skills that are highly specific to their employer or industry, and the value of those skills often disappears along with their jobs. Displaced workers often take a long time to find a new job, which translates into large chunks of lost income. More important, even after they find new jobs, displaced workers earn about 17 percent less, on average, than they earned at the jobs they lost. Research has shown that this gap in earnings tends to persist for up to 10 years. Moreover, from 2001 to 2003, job losers with education beyond high school suffered greater earnings losses on their new jobs than in any previous period for which we have data.

Next let me highlight some of the policy ideas that emerged from the conference. I will also try to point out areas where more research might be useful, and how interaction between policymakers and practitioners can facilitate that research.

Many of the changes that conference participants proposed making to the system would cost more money. So, it is worth starting with some ways that costs could also be trimmed. One place to look is our unemployment insurance, or UI, system, which is the main policy program to help workers who have lost their jobs. However, the system is better structured to assist those for whom unemployment is expected to be of short duration than those suffering longer spells, such as displaced workers.

The system could be changed to discourage firms from making temporary layoffs. Firms pay an unemployment insurance tax rate that increases with the number of workers it has laid off in the past. However, the tax rate is capped: once a firm has reached the maximum rate, it can lay off additional workers without raising its UI tax rate. Research presented at the conference suggests that temporary layoffs would be reduced by moving toward a full experience rating of the unemployment insurance system, so that each additional laid-off worker raises the tax rate.

How could the unemployment insurance system be designed to better address the needs of these workers? First, in some cases, it would probably need to last longer than 26 weeks. But, that may create an incentive problem. If unemployment insurance benefits are set too high, then displaced workers have an incentive to remain unemployed for as long as the program allows. So, we may need to create inducements to get these workers back into the labor market. For example, the government might allow workers to keep some unemployment benefits if they return to work early, or provide a "wage subsidy" that ensures the worker is better off taking a job than collecting unemployment benefits. Research suggests that such programs can shorten the length of time workers search for new jobs.

Second, a program aimed at displaced workers would probably need to help some workers acquire new skills. We have implemented and experimented with a wide range of retraining programs for as long as I can remember. Unfortunately, the costs of many of these programs exceed their benefits to society. We have had better news recently, however, when assessing retraining through the community college system. Of course, not all courses are equally valuable—for example, training to be a nurse is likely to be much more valuable than learning about the history of photography. This means there also is a role for programs to help inform displaced workers about which fields would constitute their best bets.

The Bush Administration has proposed "re-employment accounts." The proposal contains elements of the employment bonus and retraining policies I have just discussed. Unemployed workers would be allocated a sum of money that they could use to get training, and they could keep the balance of the money in the account if they took a job within some specified period of time. Seven states have been chosen as sites for a demonstration of this proposal,[1] and the project is underway in six of those seven states. What we learn from this demonstration project will influence whether re-employment accounts become available on a larger scale.

Trade Adjustment Assistance for workers displaced by international trade is a policy that is tailored to the needs of those who have permanently lost a job. Benefits are paid for longer than the typical 26-week period, and workers may receive assistance with retraining and purchasing health insurance. Older workers who are less likely to benefit from retraining may be eligible for wage subsidies. However, as was pointed out repeatedly at our conference, Trade Adjustment Assistance is really a component of international trade policy, and not a comprehensive labor market policy. Assistance is available only for workers who are certified to have lost their jobs from foreign competition and only to those displaced from manufacturing. But from the point of view of a worker, it does not matter if his or her job disappeared because of competition from New Delhi or New Jersey. We can learn from Trade Adjustment Assistance about what programs can effectively help displaced workers. But we need to apply those lessons to help all workers displaced—no matter what caused their job loss and regardless of the sector where they had been employed.

[1]The seven states were Texas, Florida, Idaho, Minnesota, Mississippi, Montana, and West Virginia, as of May 19, 2005.

In addition to public policies that attempt to address job loss, we know that firms have their own policies that come into play in a "reduction in force." Certainly many of the people in this room are well aware of the various forms these policies may take. Several panelists at our conference painted a fascinating picture of how firms decide to reduce their work force. One panelist pointed out a seeming paradox: at the same time that firms are laying off workers in the face of new technologies and competition, they are also struggling to retain and hire skilled workers. He pointed out that there may be unintended consequences associated with firms' ability to so easily lay off workers—namely that it creates an environment where it is also hard to retain workers. This is because the surviving work force takes a great deal of notice of how laid-off employees are treated. If a firm gives longer notice of impending lay-offs or offers outplacement services, then it may have an easier time retaining other workers. But if the firm treats laid-off employees poorly, then other workers are more likely to leave as soon as they get an attractive offer.

These provocative ideas lead to several interesting research questions. For example, do workers who use outplacement services do better than those who do not? Research has not answered this question. Firms that provide outplacement services are likely to be different from those that do not. Similarly, workers who choose to use these services are likely to be different from those who do not. Hopefully, by collaborating with practitioners who have insight into the process of reductions in force, researchers may be able to determine if private outplacement services affect the speed of finding a new job and the quality of that job, as well as whether firms benefit through improving the productivity of their surviving work force. If so, we should encourage more firms to provide these types of services.

In closing, let me say again that our willingness to embrace change is an important reason why the U.S. economy is dynamic and productive, and generates a higher standard of living for us all. Now, there will be people who suffer from such changes. But because these losses are part of the dynamic process that makes us all better off, society can and should help these people find their place in the new work force.

However, there is a great distance to go from "can" and "should" to precisely "who" and "how." As the pace of technological change quickens, and as more markets open to competition, job displacement is affecting an increasingly diverse group of workers. If we do not attend to the needs of displaced workers, concern about their future may block policies that help improve our overall standard of living. And this could have costly consequences for the economy as a whole if it were to stifle technology and competition. So this is another reason why we need to design policies that support openness to change by helping those who are adversely affected. Collaboration among labor researchers, policymakers, and practitioners is critical to designing such policies. As arbitrators, your first-hand knowledge of human resource practices can add a valuable perspective, and we welcome your views. Thank you again for inviting me.