The Decline of U. S. Unemployment after 1982:

what can Europe learn – or unlearn – from the American experience?

Stéphanie Laguerodie[1] and Francisco Vergara[2]

> "labor-market rigidity … is the only explanation of high unemployment that is ever discussed seriously by civil servants and central bankers in much of Europe … almost exclusive focus on this aspect of the problem is a major mistake … an intellectual failure"[3]
>
> Robert SOLOW (January 2000)
>
> "We must get past the binary and *unhelpful contrast* between 'flexibility' and 'rigidity' in labor markets"[4]
>
> Dominique STRAUSS-KAHN (April 2011)
>
> "*the priority* [regarding the labor market] must be to enhance wage flexibility … and to remove labor market rigidities"[5]
>
> Jean-Claude TRICHET (May 2011)

ABSTRACT In this paper we suggest that the role of "labor market flexibility" in bringing down American unemployment after 1982 (following the Ronald Reagan reforms) may have been exaggerated by economists who have studied this period. The lessons drawn from this episode, often presented as advice to other countries who seek lower unemployment, may thus be biased.

If the fall in American unemployment after 1982 was *mainly* due to better performing labor markets (flexibility), we would expect to find employment-growth accelerating after this date. But, as Figure 3 shows, the opposite was the case. During each successive economic cycle, employment-growth slowed down after 1982.

Instead of ascribing (most of) the fall of American unemployment after 1982 to *one fundamental cause* (flexibility), we examine the possibility that it could be the result of *several concurring causes* which, during this period, happily converged in the same direction. This, of course, does not mean that "more flexibility" is unimportant, only that is "situation-specific".

We examine here several other evolutions that could, in conjunction, explain a good deal of the fall of American unemployment after 1982 but have largely been eclipsed by the excessive focus on "flexibility". The "rate of growth of the working-age population" (Figure 4), the "level and growth of the participation rate" (Figure 5), the explosion of foreign financing, the decline of young people in the labor force, and a few other factors, may *if taken together* have contributed more than is often recognized, to the fall of American unemployment after 1982.

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[3] SOLOW, Robert , "Unemployment in the United States and in Europe: A Contrast and the Reasons", CESifo *Working Paper No. 231*, Munich, January 2000.

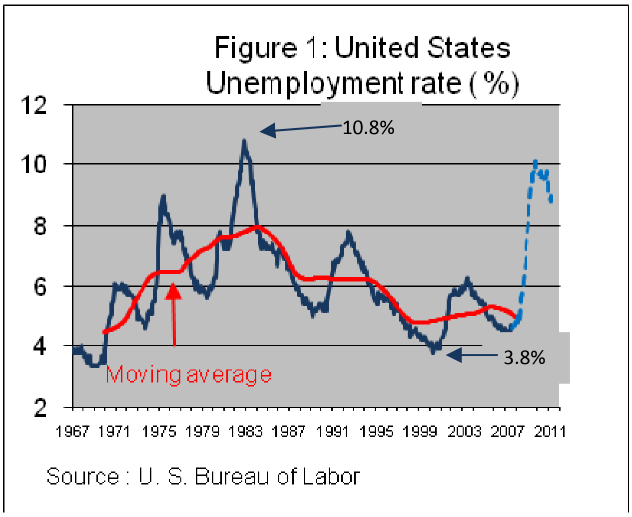
[4] STRAUSS-KAHN, Dominique, "The Global Jobs Crisis", Brookings Institution, April 13,2011.

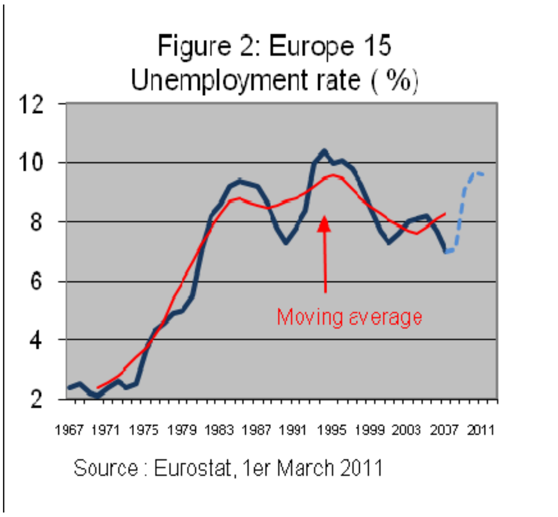
[5] TRICHET, Jean-Claude Trichet, "Introductory statement to the press conference", Helsinki, 5 May 2011.

1. Introduction

The experience of developed countries that have, in the past, gone from *very high unemployment* to *full-employment* (or something close to it), can certainly be a source of inspiration for Europe today. And one of the most interesting experiences is probably that of the United States, a country whose unemployment rate dropped from a high 10.8% (in November 1982) to 3.8% (in April 2000), and continued to fluctuate around a very low level (about 5%) for seven years, until it exploded again after 2008.

Figure 1 shows the spectacular *seven percentage-point decline* of American unemployment that we discuss in this paper. The unemployment rate – which had increased enormously on both sides of the Atlantic during the 1970s – started trending downwards in the United States after 1982, whereas it seemed to remain stuck at around 8 or 9% in Europe (as Figure 2 shows). The very cyclical American economy attained ever-lower unemployment rates at the end of each expansion, until the recent financial and economic crisis interrupted this happy pattern (as the dotted line in Figure 1 shows).





If one compares these two figures *today*, including the period after the recent Financial Crisis and the Great Recesion, the impression is that there are serious unemployment problems *on both sides of the Atlantic*. But when one compared them in the 1990s, and the first half of the 2000s, the idea that sprang spontaneously to the mind of most economists was that "the labor market" *was not functionning well in Europe*, that it was functionning better in the United States. Europe seemed to have done something wrong, something that the United States was doing right. And one of the reasons most often advanced was that European labor markets had become *more rigid* whereas American labor markets were *more flexible*.

The words "rigidity" and "flexibility", referring to labor-markets, have been used in many different acceptations. They sometimes refer to the stickiness of nominal or real wages, sometimes to legal and social obstacles to hiring and firing, sometimes to laws or customs imposing certain behavior, etc. The general idea is that moral, political and sociological forces are impeding markets from reacting as they would, had not these rigidities been there. It is suggested that these reactions would steer the economy in the desired direction if rigidities are removed.

Since our aim in this paper is to suggest other causes that could explain the decline in unemployment in the United States after 1982, we will not dwell on the different acceptations given to these words, suggesting only that they are often used a bit vaguely, alluding to the presence of some mysterious *process* or *mechanism* that is (or is not) working properly and that could explain complex phenomena that we don't understand well.

2. A very old intuition

Flexibility-rigidity explanations of unemployment have been around for quite some time and seems to arise spontaneously in the minds of trained economists whenever persistent unemployment appears. As Wilfred Beckerman and Tim Jenkinson of Oxford write in 1985, in a symposium on the unemployment of the early 1980s:

> "As in the 1930s, there is widespread belief that [today's] unemployment is largely the consequence of wage rigidity preventing wages from moving enough to restore equilibrium in the labor market"[6]

Many (maybe most) professional economists concentrated their energy on the different definitions of *rigidity* and *flexibility*, on the different ways of measuring them, on exploring the reasons why the economy was (or had become) rigid, and the different reforms that could be carried out to introduce more flexibility into the system. A few authors nevertheless questioned the validity of the idea that wage and price flexibility are always good for welfare and always work in the sense of reducing unemployment. Thus Pigou, somewhere in his *Economics of Welfare*, reminds us that much of what economists call "rigidities" are nothing else but "elements of civilization". As for Frank Hahn and Robert Solow, they (provocatively) titled their contribution to the above mentioned symposium "Is Wage Flexibility a Good Thing?" and they reminded the participants that a different opinion also existed:

> "as Tobin saw, the dynamic properties of a flexible-price system may be perverse … Keynes was right, and for the right reasons, when he argued that wage-flexibility … could propel the economy along quite undesirable paths"[7]

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[6] Beckerman, Wilfred (ed), *Wage Rigidity and Unemployment*, Duckworth, London, 1986, p. 21.

[7] Hahn, Frank, Solow, Robert, "Is Wage Flexibility a Good Thing", in *Wage Rigidity and Unemployment*, Duckworth, London, 1986, p. 6 and 15.

In the 1980s, the "reflex belief" (as Hahn and Solow politely called it) according to which "wage and price flexibility must be good for an economy"[8] gained great appeal, especially after Ronald Reagan became President of the United States and initiated a series of reforms aimed at rolling back the "rigidities" that were believed to have accumulated during the John Kennedy and Lyndon Johnson administrations (1961-1968). The idea became almost irresistible when the American unemployment rate started falling after 1982, and this happy downward trend was (quite naturally) attributed to the reforms which had taken place just before.

Though it was not always expressed clearly and explicitly, the opinion that tended to prevail in Europe was (in a nutshell) that the structural reforms inspired by Ronald Reagan – reforms that Europe hesitated to carry out – had rendered the American economy more dynamic, by making its labor markets more flexible. And it seemed almost a corollary that this was the painful path that European countries would *necessarily have to follow* if they also wanted to attain full employment. The case was masterly presented in the 1994 *OECD Jobs Study*:

> "[in continental Europe] policies to achieve social objectives were extended, with the unintended side-effect of making markets, including importantly labor markets, *more rigid* … In the United States, by contrast … labor markets *remained highly flexible*"[9]

3. One Important Mechanism? Or the Confluence of Several Factors?

The belief that rigidity was not the only cause (and not even the main cause) of unemployment in Europe, and the conviction that there existed less painful and less "socially divisive" ways of bringing unemployment down, managed nevertheless to survive. Thus, in 1999 Robert Solow writes:

> "There is a tendency in matters like this to assume that there must be *one single answer* … The conventional understanding … especially among Europeans, seems to rest entirely on *labor-market rigidities* … Consequently the only potential cure for high unemployment that is ever seriously discussed is labor-market reform and wage moderation"[10]

The idea slowly making its way in Europe was that – though this policy had undoubtedly worked in the United States – American style "structural reforms" were *not the only path* towards full employment. In 2006, for example, OECD gave the impression of revising its Jobs Strategy, recognizing that other countries (Austria, Switzerland, Japan, etc.) had attained, and maintained, full employment by other means:

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[8] Hahn, Frank, Solow, Robert, *Ibid*, p. 5.

[9] *The OECD Jobs Study, Facts, Analysis, Strategies*, 1994.

[10] SOLOW, Robert , "Unemployment in the United States and in Europe: A Contrast and the Reasons", CESifo *Working Paper No. 231*, Munich, January 2000, p. 3.

> "High employment …can *also* come from a system based on coordinated collective bargaining and social dialogue, with generous welfare benefits … while also providing security to workers"[11].

But the dominant opinion, according to which it was *mainly* labor-market flexibility that had kept unemployment down in the United States remained largely unchallenged in Europe.

4. The Cycle and the Trend

A first thing that stands-out very clearly, when one looks at Figure 1 portraying the unemployment rate in the United States during the last 45 years, is the *very cyclical caracter* of the American economy. Between 1967 and 2011, the unemployment rate flared-up *six times* and then went down just as many (if one includes the latest decline which seems to have started in December 2009).

If we want to understand *why* the American unemployment rate started falling after 1982, it seems useful then to distinguish between the *typical declines* that take place during the ordinary expansion phases of the common business cycle (phases that last about 5 years on average), and what appears to be a different and longer *underlying trend* which our moving average in Figure 1 displays, and which seems to have lasted for about 17 years (a fall that starts after 1982 and ends around 1998).

If we try to explain all (or most) of the seven percentage-point fall of unemployment (between November 1982 and April 2000) by *one important cause*, we could find ourselves combining two different (albeit intertwined) movements which have different (though interacting) sets explanations.

To be more specific, when the unemployment rate in the United States declines from 10.8% in December 1982 to 3.8% in April 2000, *two distinct movements* seem to be concurring (and maybe more than two). On the one hand we have the fall of the unemployment rate during the ordinary expansion phase of the business cycle, and on the other side there seems to be some underlying trend portrayed by *the moving average* around which it fluctuates.

If we distinguish these two movements, our task becomes easier. Instead of having to explain an almost miraculous 7 percentage-point fall in unemployment (from December 1982 to April 2000), we only have to explain the 3.1 percentage-point decline shown by the moving average (from 7.9% in 1983 to 4.8% in 1999). The rest of the fall being due to the choice of years we have made (choosing to measure from a peak to a trough) and explainable by the ordinary business cycle.

5. The Reagan-Bush-Clinton era

If we examine *the moving average* of the American unemployment rate between 1967 and 2000 (Figure 1), we can easily distinguish *two phases*. A first 16 year phase, from 1967 to 1982-83, during which the unemployment rate shows a clear tendency to rise. From business cycle to business cycle

[11] "Jobs Strategy: Policy choices that work", *OECD Observer*, May 2006.

the rate increases, reaching ever-higher peaks after each recession (6.1% in December 1970, 9% in May 1975, and finally 10.8% in November 1982). When the recoveries begin, unemployment falls for a while but doesn't manage to go back down to its preceding low. The unemployment rate seems to hit a floor that is getting higher and higher with time (3.4% in September 1968, 4.7% in October 1973, and 5.7% in June 1979). The temptation to see the work of a rising "natural rate of unemployment" becomes almost irresistible for professional economists.

After 1982 the situation is reversed and the economy enters a phase of falling unemployment that lasts about 17 years. From cycle to cycle, the unemployment rate falls, reaching ever-lower levels and becoming systematically inferior to the European rate[12]. The temptation to see the work of a rising "natural rate of unemployment" followed by a falling one, becomes almost irresistible for professional economists.

One of the most popular explanations of this 33 year-long cycle goes along rigidity-flexibility lines. After 1960, the American labor-market is said to have become increasingly rigid because of the regulations and social programs adopted under Presidents John Kennedy (1961-1963) and Lyndon Johnson (1963-1969)[13]. The situation reverses itself after 1982, when labor-market flexibility is (largely)restored following the pro-market reforms introduced by Ronald Reagan (1981-1989) and pursued by his successors[14].

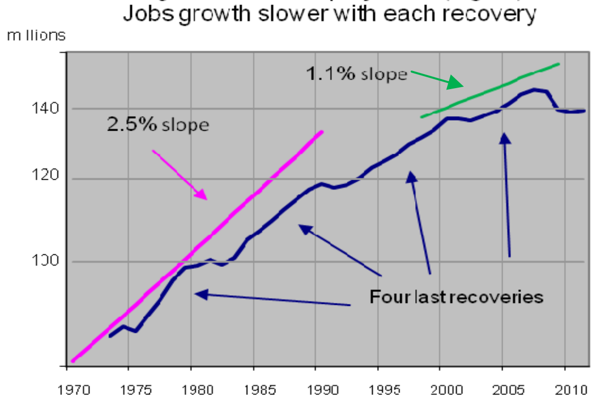
Several objections have been made against this extremely appealing explanation. If the fall in the unemployment rate after 1982 were due to *better functioning labor markets*, one would expect to see job creation accelerating after the Reagan reforms. But, as Figure 3 shows, the opposite is the case and employment-growth gets slower and slower after 1982.

[12] We are now, as everyone will have noticed, in a third very different phase, and today unemployment is between 9 and 10% on both sides of the Atlantic.

[13] Programs adopted during these years, like « *War on Poverty* », and institutions like *Medicare* and *Medicaid*, the main parts of the "*New Frontier*" and the "*Great Society*" vision for America, constituted the most profound social reforms since Roosevelt's "New deal".

[14] Deregulation of important sectors of the economy, seven year freeze of the nominal minimum wage, reduction of tax-rate for higher income brackets, etc.

Figure 3: **U.S. Employment** (log 10)
Jobs growth slower with each recovery



Source : U. S. Bureau of Labour

This does not, of course, prove that the Reagan reforms made the labor market less efficient. It could be, as OECD argues, that the environment in which markets were functioning had become so much more turbulent (oil price rises in 1973/74 and 1979/80, volatility of exchange rates after the breakdown of the Bretton Woods, waves of financial-market liberalization after 1980, etc.) that it was just too much, even for flexible American labor markets. Had not the labor markets been made more flexible by the Reagan reforms, job creation would have slowed down even more.

But this argument is weakened by the fact that in the Euro Area, subject to similar turbulences, employment was not slowing down. It was accelerating, at least until the 2008 financial crisis arrived. As Table 1 shows, between 2000 and 2008, employment in Europe was growing even faster than in the United States (1.1% per year against 0.7%).

Table 1: Employment (yearly rate of growth)

(increasing in Europe, declining in America)

	1970-80	1980-90	1990-2000	2000-08
Euro Area (12 countries)	0,4	0,7	0,7	1,1
United States	2,1	1,8	1,3	0,7

Source : Eurostat, AMECO database, 13 May 2011.

6. The Difference between “Contributions to” and “Determinants of”

Since the explanation of the fall of American unemployment, after 1982, by the flexibility argument is not as evident and unproblematic as some are inclined to believe, there seems to be no reason for not inquiring into *other possible lines of explanations*. As Robert Solow suggests, in his January 2000 Working Paper:

> “The single-minded focus on the labor market … hides other, very important lines of causality ... It is more likely that the difference between American and European

> unemployment arises from the *cumulation of several differences* in institutions and policies”[15]

Professor Solow by no means excludes the flexibility of the American labor-market as one of the explanations, but he mentions several other possible causes: the very activist American fiscal and monetary policy, the greater deregulation of American product markets (not just labor markets), and of course “just good luck”[16] in the form of low inflation allowing lower interest rates and longer expansions. Our intention in this paper is to suggest some other possible lines of explanation, demographic, sociological and political. But before, something has to be cleared up.

The factors we draw attention to should be understood more as “contributions to” changes in unemployment rather than “causes of” (or “determinants of”) these changes. The distinction between these two concepts (“contributions to” and “determinants of”) is commonplace in analysis of GDP growth and is regularly referred to by BEA (Bureau of Economic Analysis) in the United States. In the 1st quarter of 2011, for example, GDP grew at an annualized rate of 1.8% in the United States. Personal consumption *contributed* 1.9 points to this increase (more than the total), Private investment *contributed* a further 1 point, while Government expenditure *contributed negatively* with –1.1 points. Another way of saying the same thing is that personal consumption *added* to the growth-rate while Government expenditure *subtracted* from it (see for example http://fvergara.com/ContributionstoPercentChangeofRealGDP.pdf).

The “causes” or “determinants of” change in a variable like GDP, employment or unemployment, are to be sought for in *past events*, whereas “contributions to” its change are *simultaneous*. “Contributions to” are simply changes in the elements that compose the variable we are trying to understand. The study of “contributions to” can be a very useful step in several ways. It can give insights into the directions in which it might be useful to search for the causes of the problem we are trying to solve, it can suggest orders of magnitude, and it can indicate if the problem comes from a passing, transitory phenomenon or from a durable change.

7. Changes in the “Growth-rate of the Working-Age Population” and in the “Participation Rate”

One of the most important “contributions to” changes in employment and unemployment comes undoubtedly from the growth-rate of the working-age population (15 to 64 years). Since the Second World War, the working-age population never stopped growing in the United-States,

[15] SOLOW, Robert, “Unemployment in the United States and in Europe: A Contrast and the Reasons”, CESifo *Working Paper No. 231*, Munich, January 2000, p. 3 and 5.

[16] SOLOW, Robert, Ibid, p. 2.

but the speed at which it increased varied enormously. During the period which interests us here it has gone from a high 1.9% per year (around 1971) to less than one third of this rate (0.6% around 1989).

As Figure 4 shows, during the eight years of the Kennedy-Johnson Presidencies (1961-1968), it was growing at an average of 1.6% per year and accelerating rapidly. During the eight years of Ronald Reagan's Presidencies, it was growing at a low of 0.9% per year and decelerating rapidly. It would be surprising if these important changes had no influence on the observed unemployment rate. One thing we can be certain of is that they necessarily "contributed to" them, for the simple reason that they enter into *the definition* of unemployment change[17].

As we see in Figure 4, the curve showing the growth-rate of the working-age population displays *two waves* or *cycles* in the period that interests us. The first one, lasting 27 years (from 1960 to 1987), can be explained mainly by the surge of the birth rate some twenty years earlier, and the consequent arrival at working-age of the *baby-boom children*. The second, much less pronounced wave (which begins in 1990), results mainly from the first and can be explained by the arrival at working-age of the children of baby-boomers, and not by any increase in the birth rate.

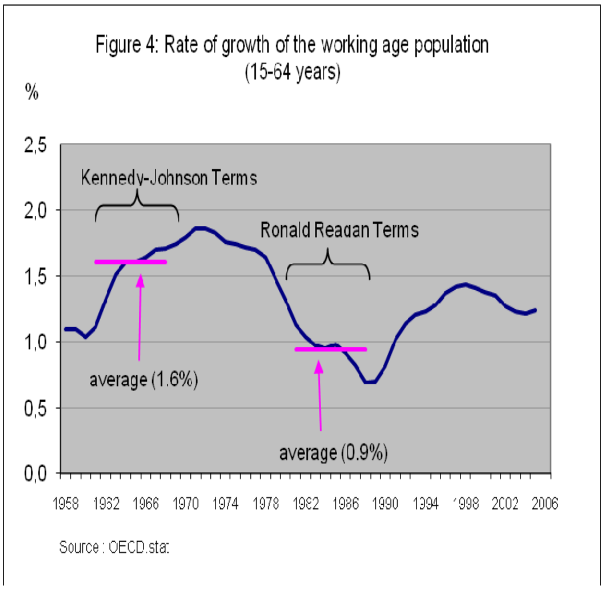


Figure 4: Rate of growth of the working age population (15-64 years)

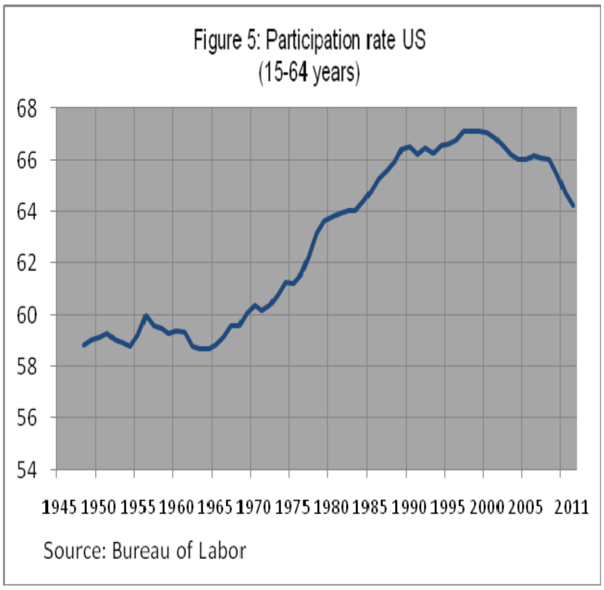


Figure 5: Participation rate US (15-64 years)

[17] The "labor force" is defined as the "working-age population" multiplied by the "participation rate". And the "labor force" is the denominator of the "unemployment rate". In a technical Appendix (in preparation), after this "qualitative" enquiry, we will develop the exact formulas expressing these "contributions to".

As Figure 5 shows, “participation” in the American labor-force (which had been relatively stable since 1948) starts growing after 1965 and accelerates enormously during the 1970s. The evolution is more than entirely explained by the growing participation rate of women as the participation rate of men is constantly falling. After 1990, this behavior changes completely. With the 1990-91 recession it stops growing, and with each following recession (2001 and 2008-09) it falls with increasing speed.

Combining these two “contributions”, we find that their magnitudes, and the timing of their turning points, coincide quite well with the rise (until 1982) and then the fall of the unemployment rate that is, a bit rapidly attributed to flexibility-rigidity causes.

Just to give an order of magnitude, we can say that if the growth-rate of the working-age population had not slowed down after 1982 and had continued to grow at 1.6% per year (the rate it was growing during the Kennedy-Johnson years), it would have counted 26 million more people in 2007, of which 18 to 19 million would have been in the labor force. For the unemployment rate to fall, as it did, employment-growth of 2% per year would have been necessary[18].

As we saw in Table 1, employment-growth was much lower: only 1.8% per year during the 1980s, 1.3% during the 1990s and 0.7% from 2000-2008. If this slowdown of employment-growth did not lead to an increase in the unemployment rate, it is because the growth-rate of the working-age population (for which jobs need to be created) slowed down even faster (at least until 1990).

If the unemployment rate did not flare-up again, when the growth-rate of the working-age population started growing again after 1990 (see Figure 4), it is no thanks to employment-growth (which continued declining), it is related to the participation rate which stopped growing just at the right time, and even starts falling.

After the year 2000, employment-growth slows-down even more. This time *two new developments* arrive just on time, and “contribute to” maintaining a low unemployment rate. First of all, the growth-rate of the working-age population has started falling again (since 1998) and the participation rate accelerates the speed at which it is falling (as Figure 5 shows).

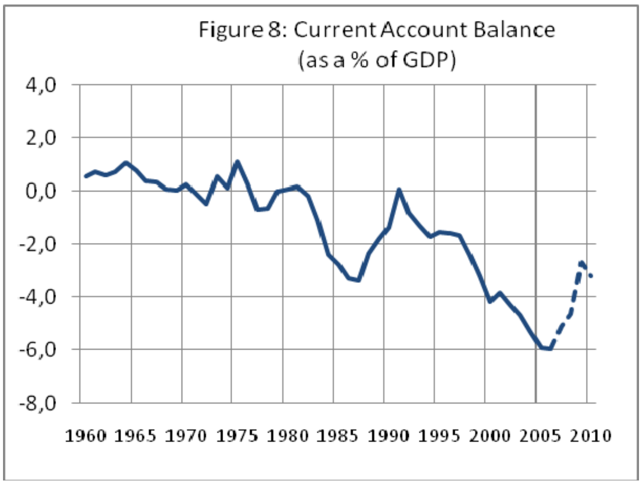
Using metaphorical language, we can say that though employment-growth (job creation) was slowing down, this did not show-up in unemployment because of favorable winds and currents. Ronald Reagan (1981-1989) had *one* strong favorable wind helping him with unemployment, a low and rapidly falling rate of growth of the working-age population. George W. Bush (2001-2008) had two winds helping him: the growth-rate of the working-age population had started falling again and the participation rate accelerated it decline.

[18] Employment would have had to grow faster than the working-age population because the participation rate was increasing until 1996.

8. Increasing deficits

In his January 2000 Working Paper, Robert Solow points to the activist fiscal policy of the United States, especially in periods of weak aggregate demand (when unemployment has tended to increase) as one of the (many) reasons for the low American unemployment-rate after 1982. But, if Government spending financed by borrowing can be considered as having a positive effect on employment (temporarily at least), there seems to be no reason why we should not consider deficit spending by the other “resident institutional units” financed by “the rest of the world” as having a similar expansionary effect. And if the additional demand generated this way increases employment, this increase (even if it only be temporary) explains some of the fall of unemployment that cannot be attributed to labor-market flexibility. Here again, the timing of this evolution is quite consistent with the idea that it contributed to the post 1982 fall in unemployment.

If we take the Balance of the Current Account as a rough indicator of net domestic spending financed by the “rest of the world”, we see that, after having been roughly in equilibrium from 1960 to 1981, it starts displaying a strongly increasing deficit around 1982, precisely when the American unemployment starts trending downwards, and even more so after 1991, just on time to stimulate employment when the growth-rate of the working-age population starts growing again (see Figure 4).



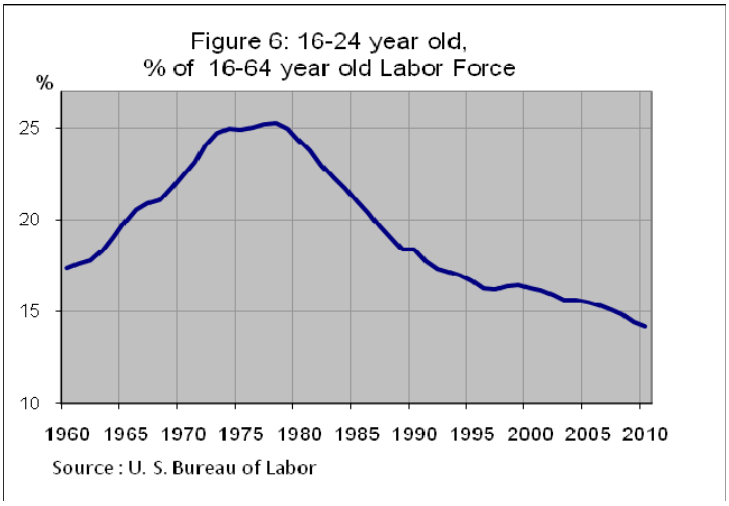
If we were speaking of the General Government “Structural Budget Balance”, this increasing deficit would be interpreted as a 0.3 point boost (or injection) to domestic demand continued during 24 successive years. Just to give an order of magnitude, and with no other intention, this corresponds to approximately 12% of the observed growth of GDP and could be considered as having contributed about 4.5 million of the 42 million jobs created after 1982.

9. Concluding Remarks

In this paper we have suggested that the role of labor market flexibility in bringing down American unemployment after 1982 may have been exaggerated, and that research into the role played by other factors (demographic, political and behavioral) have been neglected. If taken together, the combined effect of these other factors could, because of their magnitude and timing, explain much more of the American unemployment dynamic after 1982, than is commonly believed. The eagerness with which the flexibility-explanation was adopted may have been excessive

SOME OTHER LESS IMPORTANT FACTORS

10. **The Labor-Force Age Pyramid** (not developed yet)



11. **Incarceration policy** (not developed yet)