



## Confronting the Unemployment Crisis

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Policymakers seeking a path to economic recovery must first answer one crucial question: Is our persistently high unemployment structural or cyclical? If it's cyclical, then monetary and fiscal measures designed to boost consumer spending will restore the US to full employment in due course. But if we face a structural problem, then quick fixes won't work until we correct deeper imbalances that have left 12.5 million Americans without jobs.

Correcting cyclical problems is primarily the Fed's responsibility, through monetary policy. In that case, we may be on the right track already – Chairman Bernanke labeled unemployment a “grave concern,” and the Fed's latest round of quantitative easing aims to address it.

A recent unpublished paper, *The United States Labor Market: Status Quo or a New Normal?*, makes a strong case that the problem is indeed cyclical. The authors, Edward Lazear, a Stanford Business School professor, and James Spletzer, of the US Census Bureau, presented their findings at the Fed's Jackson Hole meeting in late August. They examined labor market data from the last five years and concluded that there were “no structural changes that can explain movement in unemployment rates.”

On the other hand, recent research from Harvard Business School (HBS) identified a number of structural deficiencies that fall outside the scope of Lazear and Spletzer's paper. That research was part of a major [initiative](#) involving more than a dozen HBS professors and other scholars to examine US competitiveness among global economies. The initiative's findings were published in the March issue of the *Harvard Business Review*, and interviews with participating scholars were published in the September-October issue of *Harvard* magazine.

Undeniably, both structural and cyclical forces affect the US economy to some degree. But the HBS research – because of its broader scope – presents a persuasive case that structural imbalances that built up mostly over the last 30 years are a major driver of current unemployment that will not be corrected quickly.

I'll look at both sets of research, but first let's examine what exactly leads economists to classify a problem as “structural.”

### What is a structural problem?

Lazear and Spletzer considered several ways to define structural problems: those which cannot be addressed by the Fed through monetary policy, those which cannot be addressed by either monetary or fiscal policies, those which are tied to an inadequate



supply of labor, or those which relate to the composition of the workforce and the unemployed.

The simplest definition, though, is that a structural problem is one which is long-lasting, such as a permanent mismatch between the supply and demand for labor. To the extent that Lazear and Spletzer used a definition in their paper, it was this one.

Two facts of the historical record, they argued, represent *prima facie* evidence that unemployment is a cyclical problem.

First, unemployment rose from 4.4% in the spring of 2007 to 10.0% two and a half years later, in October of 2009. "Most structural problems do not occur so rapidly," they wrote.

But the US went from full employment in August 1929 to 25% unemployment three years later with the onset of the Great Depression, and that unemployment was structural by any of their definitions. This fact is not mentioned in their research.

Instead, as their second supposedly decisive fact, they cite the early 1980s, when unemployment peaked at 10.8% – higher than its peak during the last recession. Many claimed – falsely, in retrospect – that the US was suffering from structural unemployment at that time, according to Lazear and Spletzer. Their point is that we should not heed what has turned out to be a false alarm in the past.

### **A primarily cyclical problem?**

Lazear and Spletzer concluded that "the current recession does not appear fundamentally different from prior ones, except that it is worse." They attributed the low job growth to slow economic growth.

"The problem is not that the labor market is underperforming; it is that the recovery has been very slow," they wrote.

Lazear and Spletzer examined a range of labor market data. Looking at changes in employment by age, gender, education and the industrial composition of the economy (that is, the percentage of workers in various economic sectors), they found no evidence of structural problems. Instead, they said, "the economy is continuing to move toward demographic groups and industries with lower unemployment rates, not higher ones."

Using statistical measures that compare numbers of job vacancies with the unemployed population, Lazear and Spletzer concluded that in no region of the country is there any mismatch of skills to workers available sufficient to label the problem as structural. "The unemployment rate is higher now, not because skills available are less in line with skills desired than they were in the past, but because unemployment rates are higher generally across all industries and occupations," they wrote.



Lazear and Spletzer dismissed one bit of evidence that is often cited by the structural unemployment camp: the fact that the ratio of long-term unemployed to total unemployed is higher than in prior recessions, even the most severe. This reflects the depth of the recession, they said, rather than any structural problem.

Lazear and Spletzer did not advocate any policy measures, but their conclusion – that our current unemployment is primarily cyclical – bolsters Keynesian economists who support the Fed’s aggressive monetary policies. Their findings also support economists, including Paul Krugman, who have argued that the primary impediment our economy faces right now is a lack of demand, which could be remedied by, for example, rehiring the approximately 600,000 state and federal workers who have lost their jobs since the recession began.

### **The HBS research**

Lazear and Spletzer focused only on data from the labor market over the last five years, whereas the HBS project examined trends across US industries over the last century. The project, a collaboration of research by individuals at several institutions, not just HBS, touched on a number of dimensions, including education, strategy, politics, and trends in the labor market.

A common thread across the findings was that America faces deep-rooted structural problems, many of which have been evolving over the last three decades. I’ll highlight some of those insights.

Michael Porter, an HBS professor and leading authority on strategy, coauthored the lead *Harvard Business Review* article, along with his colleague Jan Rivkin; the pair also led the HBS project. That article began, “The American economy is clearly struggling to recover from a recession of unusual depth and duration, as we are reminded nearly every day. But the US also faces a less visible but more fundamental challenge: a series of underlying structural changes that could permanently impair America’s ability to maintain, much less raise, the living standards of its citizens.”

First among the structural problems Porter and Rivkin identified was the growth in US labor productivity. After rising for 30 years, productivity levels have been sustained since the recession, according to Porter and Rivkin, only by rising unemployment and lower labor-force participation, which they called an “ominous” sign for US competitiveness.

Productivity growth can be fine, as long it is accompanied by a growth in income and an increase in standards of living. When it isn’t, though, productivity growth becomes a structural problem.



Wages and productivity both grew before 1980, but in the three decades since wages have failed to keep pace, which has led to the widest income inequality since 1928. Since 1975, the rolling 10-year average rate of jobs added to the private sector has hovered around 2% annually, but since 2001 it has dropped to below zero.

Moreover, growth of median annual income has been weak. In the two decades prior to 2007, that number grew by only 0.5% annually, and it has declined on an inflation-adjusted basis since the recession.

A major cause of the Great Depression was the sustained growth of productivity in the agricultural sector, which dominated the economy at the time, along with falling median incomes. It wasn't until the stock market crashed in 1929, however, that those structural problems were exposed and mass unemployment began.

Virtually all of the net new jobs created over the last decade were in local industries – government, healthcare and retail – according to Porter and Rivkin. Those sectors are not exposed to international competition. “That was a sign that the US was not doing well in businesses that have to compete internationally,” they wrote, labeling those shifts in the labor market as “clearly structural.”

Lazear and Spletzer acknowledged productivity growth throughout the 2000s, but concluded that it was “too early” to deem this a structural change.

### **Broader structural problems long in the making**

Structural problems throughout the economy have contributed to job losses, and the HBS research highlighted many of them, including the growing prominence of the financial sector, political gridlock and failures in our educational system.

An article by Thomas Kochan, a professor at MIT, labeled the 1980s as “the decade when everything changed.” Maximizing shareholder value became the governing paradigm for US corporations, and innovation and deregulation took hold in the financial sector. The '80s saw the rapid growth of leverage-buyout funds (and later private equity funds), which viewed corporations as tradable assets. That led to a focus on short-term results, according to Kochan. Top talent from business schools went into finance instead of the industrial sector, and the size of the financial sector as a percentage of US GDP has nearly doubled in the 30 years since.

“These trends built stronger pressure for short-term returns, which in turn prompted firms to cut jobs as a preemptive act, rather than a last resort,” Kochan wrote. “The net effect was to chip away at the more balanced view of the corporation as an entity with responsibilities to other stakeholder groups, not just shareholders.”



Porter and Rivkin cited a number of intractable political problems that have contributed to structural imbalances. These include the growing fiscal deficit, which has hampered the government's ability to invest in much-needed infrastructure projects. Strong infrastructure is essential to US competitiveness and a key ingredient to domestic job growth, they argued. Rapid growth of health care costs, a "dysfunctional" tax code, and an aging population are among the major contributors to the rising deficit, according to Porter and Rivkin.

"There's an almost universal view that our federal political system is one of the greatest threats to our economic future," Porter wrote, "because of its inability to tackle some of these issues."

Data in the HBS study also document the deterioration of the US educational system. The US ranks in the middle of the pack internationally in both reading and math scores; China is at the top on both lists. The researchers found a strong correlation between those test scores and GDP growth.

### **Repairing the structural damage**

The broad picture painted by the HBS researchers is that many long-term factors have eroded US competitiveness, and that has in turn contributed to high unemployment. While cyclical factors are surely at work, stark structural problems are also evident. Productivity in the manufacturing sector has risen while median incomes have fallen, income inequality has grown, and the result is large-scale unemployment, particularly among less-educated workers.

The US needs to create as many as 20 million jobs over the next decade to get back to pre-recession employment levels, according to Kochan. "Left to current market forces, America faces a serious jobs deficit that will last for at least the rest of this decade," he wrote.

The HBS project's findings include a plan to address competitive weaknesses, including improving corporate governance, reforming our educational system and breaking the political gridlock that impedes long-term investment.

"The decline of US competitiveness is far from inevitable," Porter wrote.

Indeed, there are signs that the trends underlying some of the key structural issues may soon reverse. The shift of jobs out of the manufacturing sector is likely to slow, as the transition to a service-oriented economy is largely complete. The fastest-growing sectors of the US economy over the next several decades are likely to include healthcare and education, where jobs will not be easily outsourced overseas.



Manufacturing in the US is likely to grow as well. Wages are rising in emerging markets, transportation and logistical costs are growing, product lifecycles are shortening, and companies are discovering “hidden costs” of outsourcing, such as hiring and retention, supervision, and intellectual-property protection, according to the HBS research.

Those trends will accelerate if they are supported by the proper policy measures. But the first step is recognizing that US unemployment reflects a number of long-term structural deficiencies, few of which can be remedied by such short-term measures as quantitative easing.

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