

Commentary: Maximum Employment and the Participation Cycle

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It was my pleasure to read Ayşegül Şahin and Bart Hobijn's paper titled "Maximum Employment and the Participation Cycle." The authors deserve much praise for a methodical look at how labor market flows contribute to our understanding of maximum employment.

The overarching question of their paper is: How do we know when the economy is at maximum employment? To help gather answers for this big question the authors pose and answer several important questions about flows.

Labor market watchers tend to study the net change in employment, participation and unemployment. However, underneath these net changes are flows that are orders of magnitude larger. And it is the flows that ultimately shape the net changes, so to better understand whether the economy is at maximum employment, it is essential to examine how labor market flows change over the business cycle.

Economists and policymakers often say that one of the benefits of a hot labor market is that it brings workers who have been outside the labor market and who would not have otherwise returned to work back into employment. This claim sometimes slips to the assumption that the number of people entering the labor force from outside the labor force increases during a hot labor market. This paper makes

it clear that a hot labor market does not change labor market entry rates. More generally, the authors find that labor market entry is acyclical—every month millions enter the labor market regardless of the state of the labor market.

This is an important finding because it makes it clear that if we wish to increase the flow of workers from outside of the labor market to inside the labor market, it will require active labor market or fiscal policies designed for that particular purpose. Monetary policy is not directly shaping labor market entry rates.

However, this should not be interpreted to mean that there is no role for monetary policy in increasing labor force participation. Labor market exits are procyclical and it is through this channel that monetary policy can directly affect the level of labor force participation.

The authors find that people are pretty path dependent, if they work today, they are likely to work tomorrow. Unemployed people have their own kind of path dependence—because they are not working, they are more likely to exit the labor force completely. Work is much more path dependent than searching for work. This finding is consistent with the literature that has found that searching for work is quite painful emotionally and declines the longer one is unemployed.¹ The result is that the employed have a low risk of transitioning out of the labor force and the unemployed have a very high risk. Therefore, as the unemployment rate rises, the flow out of the labor force increases because there are more high-risk people.

However, this is not the only effect of high unemployment rates on flows out of the labor market. The increased flow out of the labor force is tempered somewhat by a decrease in the rate at which both the employed and unemployed flow out of the labor force. When the economy is weak, the employed are less likely to quit and exit the labor force. Similarly, the unemployed are less likely to leave labor force. The intuition is that the employed know that leaving the labor force is risky during a downturn because things could get worse, they would have a tougher time seeking new employment and therefore undoing their decision to exit. Americans in general become more cautious in a downturn. Not surprisingly, this caution keeps

employed people more attached to the labor force during a downturn. Similarly, the unemployed during a recession may feel reassured or take comfort in being part of a period of national, rather than just individual, job loss slowly their likelihood of exiting. Or it may be that public policy increases to unemployment insurance may keep them somewhat more attached to the labor force. Another explanation is that the unemployed are more positively selected during downturns, so these types of unemployed people are less likely to exit unemployment.

While there are two contrasting forces: the increase in the number of unemployed raises the flow out of the labor market and therefore puts downward pressure on the labor force participation rate; the exit rate from employment and unemployment to out of the labor force slows during a recession, putting upward pressure on the labor force participation rate. The second effect is much smaller than the first effect and on net a rise in the unemployment rate leads more people to exit the labor force.

This finding provides new insight into how an economic recovery leads to a gradual rise in labor force participation. It does so through increased employment stability: getting people into jobs that they will then stay in. To quote the paper “When someone finds a job and moves from unemployment to employment, she is more likely to remain in the labor force going forward.” So, a good economy does not pull in new workers so much as it retains workers.

Was Our Intuition About Vulnerable Workers and a Hot Labor Market Wrong?

While flows into the labor market may be acyclical, the composition of who is flowing into the labor market is unlikely to be acyclical. Selection by employers in determining who to hire and fire will change the composition of people into unemployment over the business cycle. A slight downturn leads employers to let go of low performers. As the downturn deepens, they need to let go of more people and therefore higher performers. The unobservable skill level of workers undoubtedly shapes the speed with which they return to employment as well as their likelihood of exiting the labor force. As the recovery begins, higher-skill workers return to work more

quickly. Moreover, the flow into jobs from out of the labor force is also likely positively selected during a downturn and in the early stages of a recovery.

The unemployment rate tends to fall first for more highly educated workers, and stays elevated longer for minority workers and those with less education. As a result, more vulnerable workers have higher exit rates out of the labor force for longer into the recovery. As the recovery proceeds and the unemployment rate falls, the share of vulnerable workers in the pool of people not in the labor market increases. That means that the likelihood that a labor market entrant is a vulnerable worker is likely to be higher the tighter the labor market. Thus, while the magnitude of labor market entry flows may be stable, those entrants will likely be different in terms of their previous attachment to the labor market as the recovery progresses.

The short-hand comment that a hot labor market pulls in more vulnerable people may not be wrong, but the mechanism may be different than our previous arguments. It is driven not by a change in the magnitude of the flows, but by a change in the composition of those flows. The important finding for monetary policy is that it is crucial to get the unemployment rates of all groups to their lowest sustainable level before tightening.

Can We Keep More People in the Labor Force by Employing Them in a Recession?

The challenge of the findings in the paper is that if we push the results to their logical conclusion, we can completely end the cyclical component of labor force participation if we pay people to stay employed. Taken too far, it implies that we could create jobs in which people do anything either of value (public works projects) or not (digging holes and filling them back up), as long as there is no change in unemployment. Because with no rise in the unemployment rate the flow out of the labor market would be left with only the procyclical component—therefore the labor market exit rate would slow. Because labor market entry rates are acyclical, they would be unchanged. Labor force participation would therefore rise in a downturn in which we paid people to be employed.

Many people speculated during this pandemic-induced recession whether we should have paid more employers to hang onto their workers. Would we ultimately have recovered more quickly if we had done so? The paper implies that these are policies which warrant further scrutiny. But it would be a mistake to take the results of this paper to its logical conclusion that keeping people employed would mean no decline in the labor force during a downturn.

An important reason that people who are employed are less likely to exit the labor force is because they are in jobs for which they have some talent and affinity. If we are employing people in jobs that cannot last, that are the equivalent of unemployment insurance with more headache surrounding it, it is possible that the recovery could be slower as people doing their useless make-work jobs would have less time to search for work, develop new skills, and simply think hard about their next steps. The psychological attachment that creates the large difference between the rate at which the employed and the unemployed exit the labor force would likely be at least partially missing in a world in which people are paid to be in useless, transitory jobs. If these jobs are good fits, in companies that can survive the downturn then it is quite likely that preserving the worker-job bond will be beneficial. But otherwise, the labor market flows in this paper should be interpreted as what happens given our current (lack of) active labor market policies and the average composition of jobs in the economy over the period that they are analyzing.

How Should We Think About Trends in Labor Force Participation?

The paper argues that monetary policymakers can largely ignore the large underlying trends in labor force participation. These trends remain somewhat poorly understood and so being able to abstract from them is a useful exercise. Male labor force participation has trended downward for more than 50 years, women's labor force participation trended up before flattening out in the 21st century and potentially resuming its upward trend in the five-year period prior to COVID.² Older workers' participation has trended up. And demographic shifts have pushed overall labor force participation down.

This paper argues that the Federal Reserve can abstract from these trends because they aren't shaped by cyclical factors. The stability of the relationship between cyclical participation rates and unemployment rates means that the Fed can focus on just the cyclical component. Moreover, it should focus on only the cyclical component because it cannot impact trend labor force participation. This may be right, but I would like more evidence, primarily because of heterogeneity across workers in the likelihood that a spell of unemployment pushes them out of the labor force.

There are big differences across groups in labor force exit and entry rates. For example, mothers with young children who are employed and then experience a spell of nonemployment go on to experience longer spells of nonemployment. Will widespread job loss among mothers ultimately shape trend labor force participation by putting them on a different trajectory? Will that employment loss be countered by fathers? On net, labor market flows may look similar, but the labor market is assuredly changed.

While the primary impact of recessions is moving people from employed—where they are likely to stay in the labor force—to unemployed—where they are an order of magnitude more likely to leave the labor force, there is important heterogeneity in who finds employment and unemployment a more or less sticky states. And it seems likely that these differences ultimately shape trend participation rates.

One unique aspect of our recession is that this is the first service-sector-led recession. Is a waitress who becomes unemployed equally as likely to enter a long spell of nonemployment as a manufacturing worker? What is puzzling about the findings in the paper is that I would have suspected that who loses a job, what kind of job they previously held, the industry that they work in would impact the path of labor market exit and entry for years to come.

Labor force participation trends are certainly driven at least in part by other trends. In the 1990s recession very few women in their 30s and 40s who became unemployed would have had small children at home because most women had their children in their early 20s at

that time. The swift rise in the age of fertility means that a 35-year-old woman laid off today is much more likely to have small children at home. My prior would be that the chance that unemployment becomes an all-absorbing state would reflect factors like labor market experience and opportunity costs like children at home. More generally, I'm puzzled by the lack of interaction between trend labor force participation, compositional shifts in demographics, and the cyclical component. For example, older workers tend to be less likely to lose jobs in a recession, but more likely to exit the labor force conditional on losing a job.

Conclusion

The authors have shown the important of employment stability in boosting the labor force. And this makes the case for much stronger active labor market policies like helping workers find jobs. It also provides some hope that some of the unusual patterns from this recession may not stick. For instance, we have seen an unusual decline in labor force participation among older workers which was driven at least partially by their losing jobs as the paper would predict. Going forward as older workers stay more continuously employed the labor force participation rate among older workers will likely return to pre-pandemic levels. Similarly, the large decline in labor force participation among women was largely, but not completely, driven by the disproportionate rise in unemployment among women. Lowering the unemployment rate among women should help stem the loss in their labor force participation rates and ultimately lead to its recovery. The warning in the paper is that a full recovery in labor force participation takes time and can only happen if the decline in unemployment is widespread. One thing is clear—a broader range of employment and unemployment indicators is essential to identifying maximum employment.

Endnotes

¹Krueger and Mueller, 2011. “Job Search, Emotional Well-Being, and Job Finding in a Period of Mass Unemployment: Evidence from High-Frequency Longitudinal Data,” *Brookings Papers on Economic Activity*.

²Tüzemen, Didem, and Thao Tran. 2019. “Women Are Driving the Recent Recovery in Prime-Age Labor Force Participation,” *Economic Bulletin*, Federal Reserve Bank of Kansas City, Kansas City, Missouri.