



**Finding Workers in a Low-  
Unemployment Era**

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October 14, 1999

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Over the last few years, policymakers have become increasingly concerned about finding workers. With unemployment low, there is a widespread belief that labor markets will inevitably tighten to the point at which wage and price pressures will appear. Indeed, the most recent Federal Open Market Committee statement cites “a decreasing pool of available workers willing to take jobs” as a reason to adopt a bias toward tightening in the future. Clearly, finding workers in a low-unemployment era is a topic relevant to the general public and the Federal Reserve alike.



In this presentation I address four questions. First, precisely how low is the unemployment rate relative to historical norms? Second, could it be the case that tight labor markets are triggering inflation? Third, are there sources from which additional workers can be obtained? Finally, can government policy changes mitigate the problem of tight labor markets, and does this have any implications for the Fed?

### The unemployment rate today and its relationship to inflation

Over the last few decades, the unemployment rate has been as high as 10.8%. It now stands at a thirty-year low of 4.2%. Conventional wisdom says tight labor markets make it difficult to find workers, which leads to higher wages and higher prices. Could it be the case that unemployment is “too low”?

Figure 1

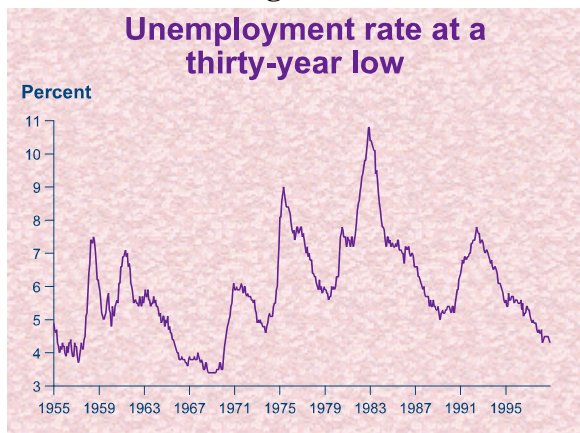
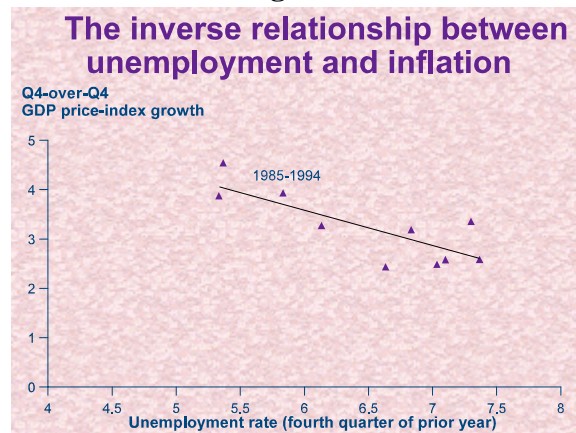


Figure 2

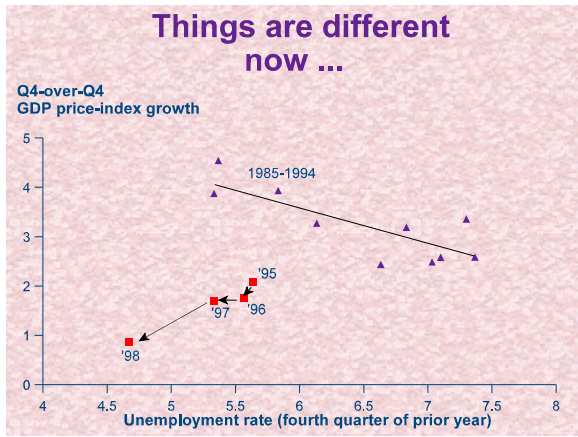


Between 1985 and 1994, there appeared to be an inverse relationship between unemployment and inflation. In years when unemployment was low, inflation tended to be relatively high. In years when unemployment was high, inflation tended to be relatively low. If the relationship given in Figure 2 were to hold today, an unemployment rate of 4.2% would almost certainly trigger inflationary pressures.

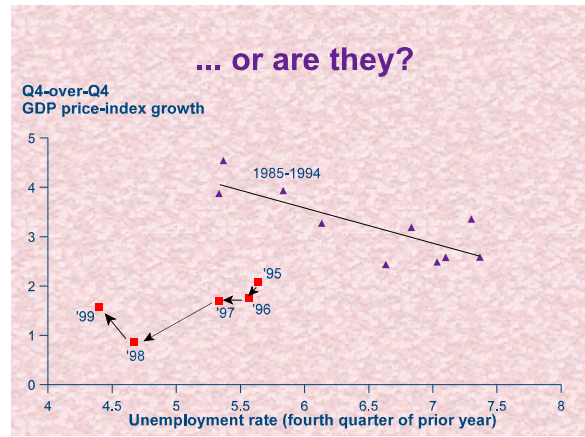
The 1995 to 1998 period broke the pattern of past years, however. Inflation and unemployment fell to levels not seen in a generation, suggesting it is possible—at least for a while—to have lower unemployment without higher inflation.

But in 1999, a further reduction in unemployment coincided with an increase in inflation. It is certainly too early to say that a new era of higher inflation is upon us. Indeed, some measures of inflation such as core CPI are as low in 1999 as they were in 1998. Still, economists and policymakers are beginning to wonder whether labor markets are finally tight enough to trigger inflationary pressures.

**Figure 3**



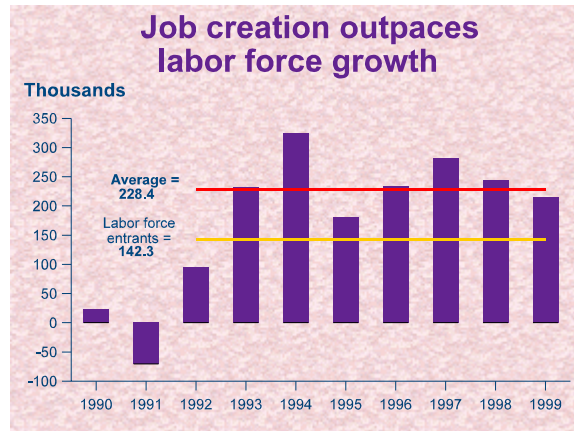
**Figure 4**



### Finding workers

On average, the American economy creates 228,400 jobs each month. Many of these jobs are filled by immigrants or by teenagers who enter the job market for the first time, but these sources of natural labor force growth are not sufficient to maintain the current level of job creation. Thus far, the gap has been filled in part by reductions in the unemployment rate. However, the unemployment rate cannot continue to decline forever. Other sources must be found for workers.

**Figure 5**

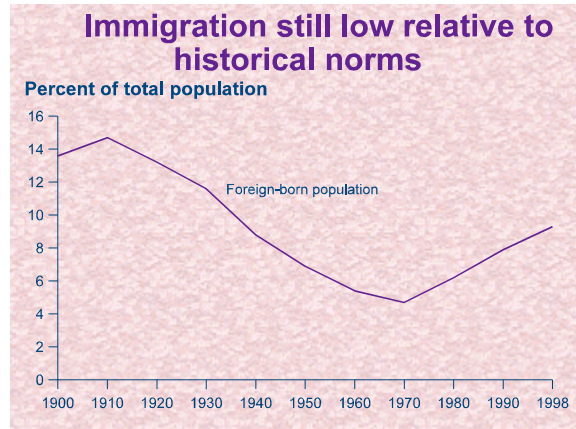


Apart from demographics and a lower unemployment rate, workers can be obtained either by raising the population growth rate in America or by encouraging Americans outside the labor force to enter it. With respect to population growth, more births can make a contribution over the long run, but immigration is the only way to increase a country's population in a timely fashion. As far as increasing labor force participation is concerned, there are at least two important and under-utilized pools in America from which people could be drawn into the labor force: retirees and welfare recipients.

## Immigration

Immigration is still low relative to historical norms. More importantly, demand for entry to the United States remains (by a variety of measures) strong. While an “open borders” policy is viewed as unrealistic by most observers, a number of proposals have surfaced in recent years to allow more skilled immigrants to enter the country. Skilled immigrants possess badly needed talents, can raise the overall productivity level in the American economy, and are likely to have relatively low demand for the social safety net.

**Figure 6**



## Social Security recipients

Labor force participation among the population as a whole has been relatively stable during the 1990s. However, beneath this placid surface lies important differences for seniors. Senior labor force participation is well below the rate for the population as a whole. To some extent, this represents the fruit of a wealthier society—seniors are now earning enough during their lifetimes that they can afford to retire at an earlier age than could past generations. But could any of it be due to bad government policy?

**Figure 7**



**Figure 8**

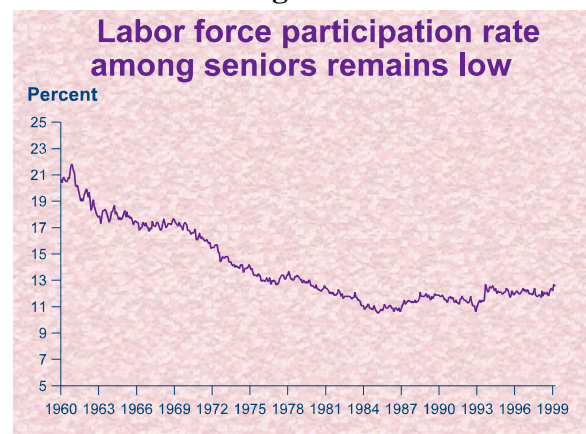


Figure 9 gives the estimated tax rate of a hypothetical Social Security recipient between the ages of 65 and 69 who chooses to work. Remarkably, workers of this age are hit with four different forms of taxation. First, they must pay income taxes on their earnings. Second, they must pay the Social Security payroll tax. Third, they must surrender 33 cents of their Social Security benefits for each dollar they earn. Finally, a portion of their benefits are themselves subject to the income tax. In the example given here, the individual's marginal tax rate becomes 62.2%—high enough to discourage almost any moderate-income senior from working.

**Figure 9**

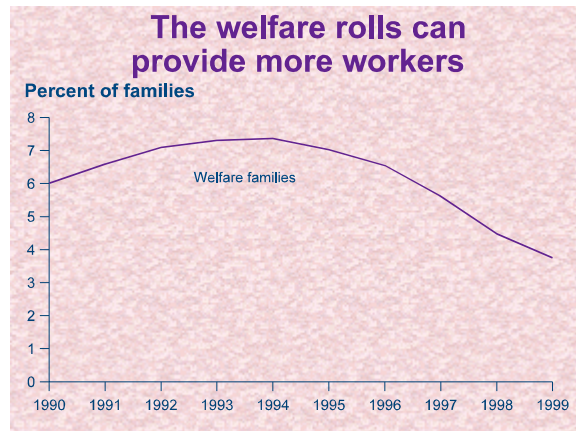
<b>Marginal tax rate on a Social Security recipient</b>	
Age	65-69
Income	\$26000
Income tax	15.0%
Payroll tax	7.6%
Benefit cut	33.3%
Benefit tax	6.3%
<hr/>	
Total	62.2%
Adjustment	-20.0%
<hr/>	
TOTAL	42.2%

To some degree, this rate is offset by a Social Security benefit adjustment such an individual will receive later in life. But even if individuals are aware of this and care enough about their long-term financial situation to take it into account, they face a marginal tax rate almost twice as high as a younger American would—42.2% versus 22.6%.

### **Welfare recipients**

It may also be possible to encourage greater labor force participation for welfare recipients. Before welfare reform was implemented, the American welfare system essentially gave a permanent allowance to any one-parent family whose head of household did not work. As shown by Figure 10, the welfare reform law proposed in 1994 has—along with the strong economy of recent years—had a dramatic effect on the percent of American families who receive welfare. Welfare reciprocity is now down to its lowest level in thirty years. And while conventional wisdom suggested most welfare recipients would be unemployable, a recent government study found that two-thirds of adults who leave the welfare rolls move directly into a job and up to four-fifths work within a year of leaving the welfare rolls.

**Figure 10**



## **Policy proposals**

A number of proposals have been suggested to gain workers from these sources. Three such changes are reforming the Social Security laws that discourage work for people between the ages of 65 and 69, raising the number of H1-B visas available to skilled foreign workers who wish to immigrate to the United States, and continuing the welfare reforms begun in the 1990s. Taken together, these proposals would bring more than a million new workers into the labor force over the next six years.

No single policy change will be sufficient in and of itself to deal with the problem of labor market tightness. However, these three proposals, and others like them, would go a long way toward alleviating labor market tightness in the American economy.

## **Implications for the Fed**

Our current unemployment situation, the evolving relationship between unemployment and inflation, and the available sources for new workers have at least four implications for the Federal Reserve System. First, labor markets are indeed tight and the Fed must continue to watch for signs of inflation. Second, the Fed should not act with undue haste against low unemployment because the once-strong relationship between unemployment and inflation may have changed. Third, it should be remembered that tight monetary policy isn't the only possible response to tight labor markets. Finally, better public policy can add workers to the American economy and help sustain the current low-inflation, low-unemployment era.