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Economics Group

Special Commentary

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Long-Term Unemployment: Costs & Consequences

Executive Summary

During Chairman Ben Bernanke's remarks at the Federal Reserve Bank of Kansas City Economic Symposium in Jackson Hole, Wyo., the chairman made particular reference to the problem of the "extraordinarily high level of long-term unemployment." As faithful readers know, this has long been a research topic in our work for several reasons. First, long-term unemployment is an economic issue because it reduces growth in the short run and potential growth in the long run. In the short run, it leads to lower consumer spending; in the long run, it leads to lower productivity of workers. Second, there is the credit issue, where the long-term unemployed tend to fall behind on their credit payments and thereby give rise to consumer delinquencies and, in the case of housing, defaults. Third, there is a social dimension to this issue as the long-term unemployed tend to drift away from mainstream society and their potential contribution to society in general is lost. At Jackson Hole, the issue of long-term unemployment came up in several sessions, and we would like to highlight some views on this issue.

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This Employment Cycle Is Different

More than two years after the recession ended, the unemployment rate remains staggeringly high at 9.1 percent (Figure 1). The depth of employment losses, at 8.8 million jobs, has made for a lengthy, drawn-out recovery in jobs (Figure 2). This pattern reinforces the view that this employment cycle is quite different than prior cycles. Only 1.9 million jobs have been recouped, leaving employment 5 percent below its prerecession level. Moreover, the headline unemployment rate does not fully capture the severity of the unemployment experience for millions of Americans since the character of unemployment has become far more long term than merely a cyclical issue. Of the 14 million unemployed, nearly half have been out of work for more than six months. The average duration of unemployment is at its highest mark in history at more

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Figure 1

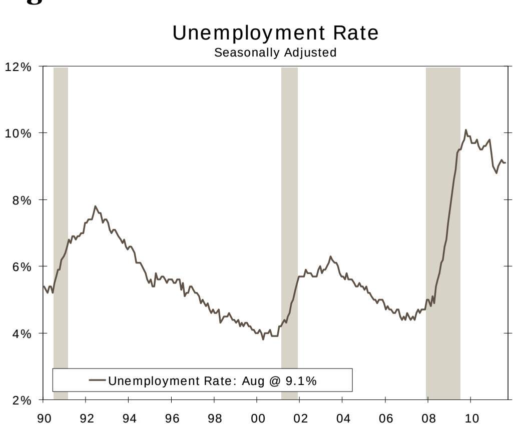
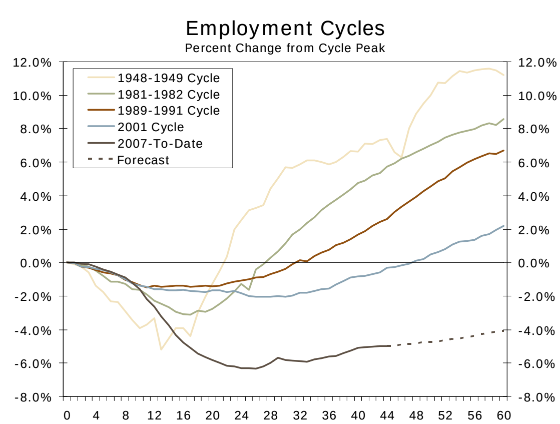


Figure 2



Source: U.S. Department of Labor and Wells Fargo Securities, LLC

Together we'll go far

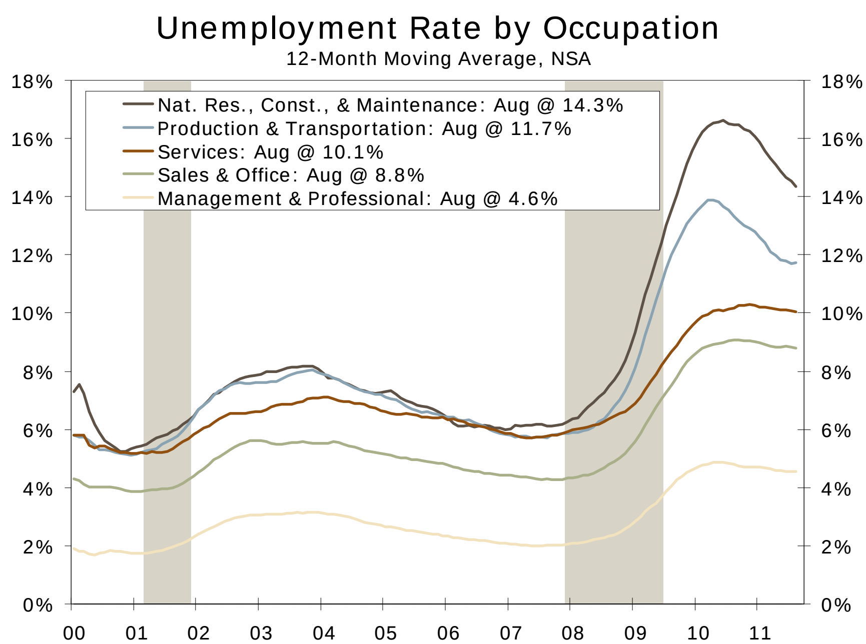
than 40 weeks. Meanwhile, the median duration of unemployment has edged higher to 22 weeks. The discrepancy between the mean and average duration suggests that a small fraction of workers face severely long spells of unemployment.

Why Are Millions Unemployed?

Long-term unemployment arises because there is a mismatch between the skills demanded by employers and the skills offered by workers.

Long-term unemployment arises because there is a mismatch between the skills demanded by employers and the skills offered by workers. This approach emphasizes the microeconomics—a bottom-up approach—rather than the top-down approach often adopted by others. We believe it also identifies the essence of the problem—the mismatch between skills needed and skills possessed. There is also the problem of limited geographic and occupational mobility. This geographic limit has been reinforced by the collapse in housing prices in many areas. The occupational limit has been reinforced by the drastic reduction in residential construction that has left many of those workers ill-prepared to pursue opportunities in other fields. Figure 3 provides a vivid illustration of the occupational problem as the unemployment for construction workers is significantly higher than that of any other occupational group.

Figure 3



Source: U.S. Department of Labor and Wells Fargo Securities, LLC

Older workers have a shorter time horizon to retirement and therefore the potential return to the educational costs of developing a new career is less than the returns of younger workers pursuing the same career.

Occupational issues are also evident in the commentary that many employers, especially in the technical fields, go begging for workers, even in such hard times when the unemployment rate is above 9 percent.[1] Construction workers cannot easily move into computer technology or software development. Moreover, the price of adjustment is particularly high and often prohibitive for those in their middle years. Older workers have a shorter time horizon to retirement and therefore the potential return to the educational costs of developing a new career is less than the returns of younger workers pursuing the same career. It is indeed hard to teach an old dog new tricks—not impossible, just hard.

Overcoming geography represents significant search costs to workers seeking new opportunities, although perhaps they are a bit less in the internet era. While the internet may help reduce search costs, the physical and emotional moving costs remain a barrier. These costs are compounded by the weak housing market today that causes many to face a sunk cost bias. Sunk cost bias is the

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[1] **See for example "Job Openings go begging in Michigan", Mining.com, Aug. 14, 2011**

human reaction that it is difficult to take a loss today in the hope that perhaps, someday, the price will rebound. Our internal wiring makes it difficult to take that financial loss.

In the United States' past, we have experienced many episodes of this geographic structural unemployment as evidenced by the mine shutdowns in the West, the Dust Bowl of the Southwest and the Rust Bowl experience of the Midwest. Today, the geography appears to be along the lines of the housing bust with an additional twist of demographic movements that emphasize a shift in population from the Midwest and Northeast to the South and West. Within many states, the geographic disparity in home prices makes even within-state moves more difficult as cities such as Los Angeles and San Francisco recover but the Central Valley of California lags. Such in-state disparities are also common in states such as Illinois, North Carolina, New York and Massachusetts, where large urban centers that are driven by the service economy outpace their small city manufacturing/construction based brethren (Figures 4 & 5).

Figure 4

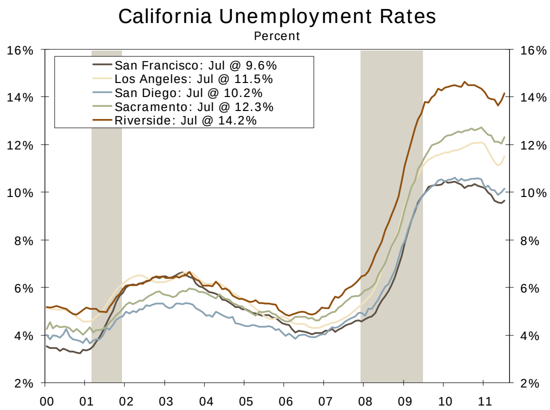
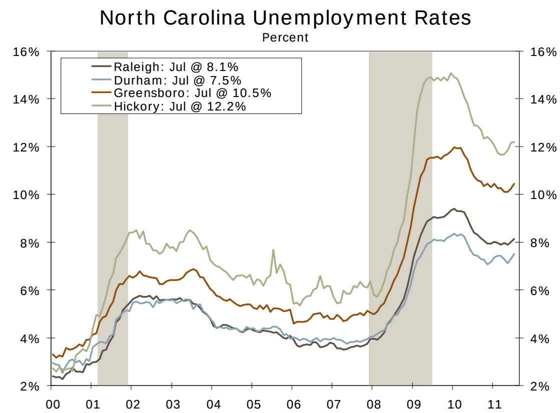


Figure 5



Source: U.S. Department of Labor and Wells Fargo Securities, LLC

Reservation Wage and the Value of Information

Moreover, we should recognize that the labor market is also characterized, in our view, by inflexible wages on both the demand and supply side in the short run. Workers have a sense of their value in the marketplace. Employers have a sense of what they are willing to pay. However, when the labor market is subjected to a series of shocks, the sense of value for both workers and employers may, and often does, deviate from the new realities in the marketplace. During the upside of the economic cycle, employers are often surprised at what they have to pay to get the talent. On the downside, workers are often disappointed in the jobs and salaries they have to accept.

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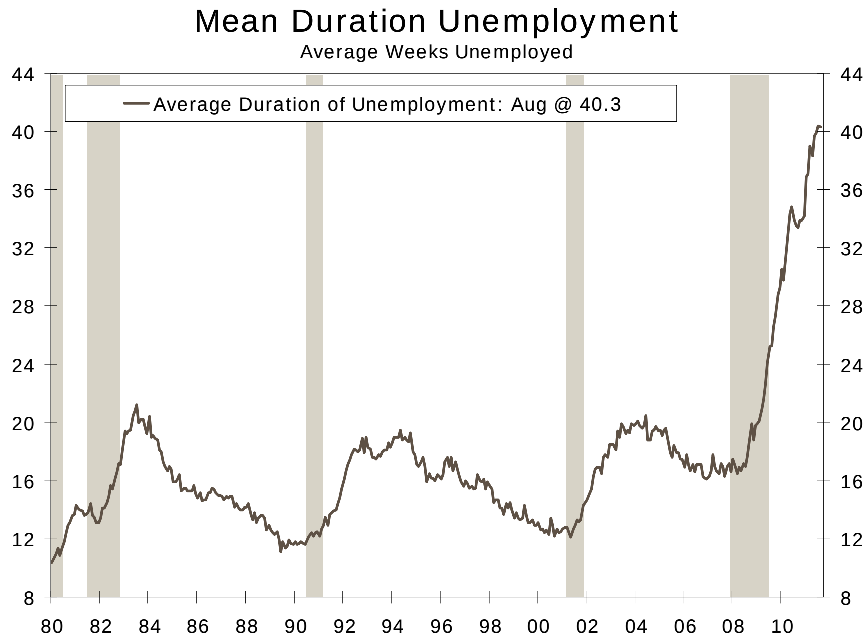
Reconciling the sense of value and the realities in the marketplace takes time, as evidenced in the average duration of unemployment illustrated in Figure 6. Often, recently unemployed workers do not take the first job offered or available because that job may not have similar wages and benefits to the job they lost. Yet individual workers may fail to recognize that a broader change in the job market has occurred and that the old wage/benefit combination is no longer available. This is particularly difficult when job losses occur in the very well-paid blue or white collar professions.

Figure 6



Source: U.S. Department of Labor and Wells Fargo Securities, LLC

Information is of paramount importance here and yet, as we have seen in the current recession and subpar recovery, the pace of economic and job growth has been difficult to judge. Therefore, misjudgment by both workers and employers is easy to understand.

Economic Costs

Long-term unemployment brings with it greater economic and social costs than the run-of-the-mill unemployment of prior economic cycles.

Long-term unemployment brings with it greater economic and social costs than the run-of-the-mill unemployment of prior economic cycles, thereby making this cycle far more difficult. On the economic side, high unemployment reduces consumer spending as those out of work pare back on expenditures. Output also falls as fewer available resources are put to productive use. This can be measured by the output gap (Figure 7), which currently stands at nearly $1 trillion. Future output is also at risk as long-term unemployment reduces the productivity of those workers. Current skills can atrophy, and keeping up with the latest technology becomes more difficult. This, in turn, makes learning new technologies and processes more onerous as instead of learning in incremental steps, new hires must learn in leaps.

The economic costs of long-term unemployment extend further to credit issues. After not collecting a paycheck for more than six months, mortgages and other loans of the long-term unemployed become increasingly difficult to pay as savings dwindle. The wide-reaching effects of this can be seen in the recent housing market collapse. Early on in the housing crisis, delinquencies and foreclosures rose in areas with a large share of subprime ARMs after rates reset, but a second and more extensive wave of delinquencies hit as the economy deteriorated and borrowers lost their jobs and income (Figure 8).

Figure 7

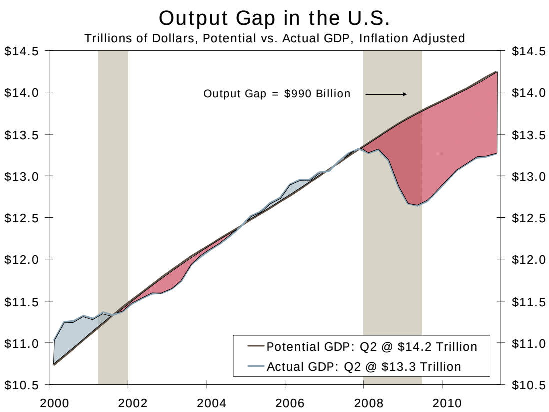
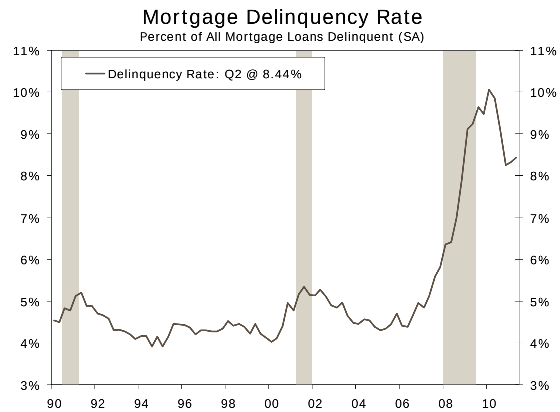


Figure 8



Source: U.S. Dept. of Commerce, CBO, Mortgage Bankers Association and Wells Fargo Securities, LLC

Economic Costs Become Social Costs as Labor's Love Is Lost

Long-term unemployment, as well as the fear of long-term unemployment, has altered the participation rates across all age cohorts—from the young to the old. Moreover, the negative wealth effect associated with the Great Recession has produced some unanticipated results as the participation rates of older workers has risen in contrast to the expectations of many that early retirement was the preferred option of many workers (Figure 9).

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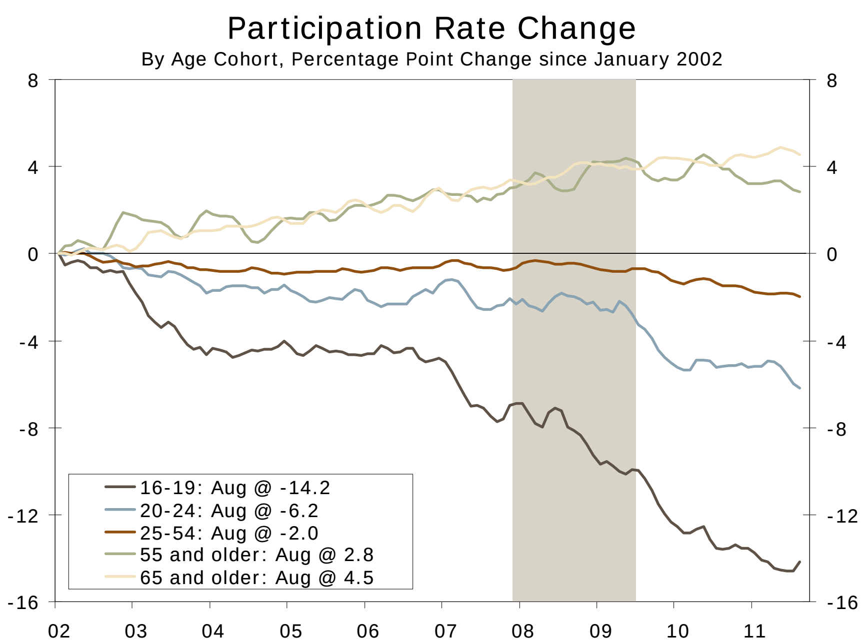
Figure 9



Source: U.S. Department of Labor and Wells Fargo Securities, LLC

As a result, in an odd twist to the expected pattern of the labor market, the participation rates of older workers has actually risen since 2002, while that of younger workers has declined. Older workers were expected to retire and start second careers. Younger workers were supposedly eager to start their careers. Well, it has not worked out that way. The decline in labor force participation of the young and an increasing participation rate of older workers is pronounced and not likely to be a random event. Labor force participation of the youngest cohorts in the economy has been trending downward over the past decade, but has fallen precipitously in this last recession. Part of the trend can be attributed to a longer-term shift toward higher education, which should help the job prospects of those earning a degree. However, while the number of 16-24 year olds not looking for a job due to schooling has increased 122 percent since the recession began, discouraged workers in this age group increased by 66 percent.

With a greater percentage of the population out of work, the burden of support falls over fewer people.

Both the decline in participation and the rise in long-term unemployed create broad implications for our society. The long-term unemployed are less likely to find employment as employers favor workers with more recent job experience and professional networks deteriorate over time. Having been out of work for more than six months, the long-term unemployed typically have little savings left to draw on and must turn to others for support, be it family, friends, charities or the government. Those out of the workforce must similarly be supported by others. With a greater percentage of the population out of work, the burden of support falls over fewer people. In a society accustomed to steady improvements in living standards and a given government safety net, fulfilling these expectations becomes increasingly difficult with such a large share of the population unable to find work or not even searching.

Conclusion

The record duration of unemployment will impede the already flagging recovery by limiting current and future growth, weighing on credit conditions and straining household and public finances.

Long-term unemployment creates long-term costs not just for the unemployed, but for the broader economy and our society. The record duration of unemployment will impede the already flagging recovery by limiting current and future growth, weighing on credit conditions and straining household and public finances. There is no easy or quick fix to reducing the scores of the long-term unemployed. However, training programs, such as those in Georgia and New Hampshire, that let employers try out unemployed workers while they continue to collect insurance may offer some hope to those out of work for long periods.[2] The unemployed get to update their skills, while employers receive a break on training costs. Much more will need to be done to reduce the prevalence of long-term unemployment, including finding ways of keeping those out of work for a long period in the labor force. This is an issue that will continue to receive our attention for some time to come given the long-term consequences it will have on our economy.

[2] **Georgia Work$**; **New Hampshire Return to Work**

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