Are Employers Unwilling to Hire, or Are Some Workers Unwilling to Work?

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By Casey B. Mulligan

Casey B. Mulligan is an economist at the University of Chicago.

President-elect Barack Obama was not the first University of Chicago professor to serve in the United States Senate. More than 50 years ago, a professor named Paul Douglas became a United States senator representing Illinois.

As an economics professor, Professor Douglas wrote about the supply and demand for labor. Some of his techniques can lead us to a surprising conclusion about today's recession: The recent decrease in employment may be due less to employers' unwillingness to hire more workers and more to workers' unwillingness to work.

As you've probably heard, employment has been falling over the past year. After peaking in December 2007, employment fell 1.4 percent over the next 11 months. Hours per employee also fell. As a result, if total hours worked had continued the upward trend they had been on in the years before the recession, they would be 4.7 percent higher than they are now.

Explanations for the decline — like most everything in economics — can be classified in two ways: supply or demand.

In many recessions, the demand for labor gets much of the blame. The demand explanation says that, with orders for their products down, many companies have trouble finding productive uses for employees. Some workers are then let go. In this view, productivity — the amount produced per hour worked — should decline because reduced productivity is a driving force of layoffs. (Gross domestic product thereby declines for two reasons: fewer workers and less productivity per worker.)

Indeed, hourly productivity did decline in the 1981-82 recession, falling three out of four quarters for a cumulative peak-to-trough decline of 2.3 percent. Productivity fell faster and longer during the Depression.

The second type of explanation is reduced labor supply.

Suppose, just for the moment, that people were less willing to work, with no change in the demand for their services. This means that employees would have to be more productive because they have to get by with fewer workers.

Of course, people have not suddenly become lazy, but the experiment gives similar results to the actual situation in which some employees face financial incentives that encourage them not to work and some employers face financial incentives not to create jobs.

Professor Douglas gave us a formula for determining how much output per work hour would increase as a result of a reduction in the aggregate supply of hours: For every percentage point that the labor supply declines, productivity would rise by 0.3 percentage points.

As mentioned earlier, in late 2008, labor hours were 4.7 percent below where trends from previous years would predict the number to be. According to Professor Douglas's theory, this means productivity should rise 1.4 percent above its previous trend by the fourth quarter.

So let's take a look at the numbers. Unlike in the severe recessions of the 1930s and early 1980s, productivity has been rising. Through the third quarter of 2008, productivity had risen six consecutive quarters, with an increase of 1.9 percent over the past three, or 0.7 percent above the trend for the previous 12 quarters.

Because productivity has been rising — almost as much as the Douglas formula predicts — the decreased employment is explained more by reductions in the supply of labor (the willingness of people to work) and less by the demand for labor (the number of workers that employers need to hire).

Why would some people have fewer incentives to take a job in 2008 than they did in 2006 and 2007 (and employers fewer incentives to create jobs)?

I will tackle that question in my next post, but even without a specific answer we learn a lot about today's recession from the conclusion that labor supply – not labor demand – should be blamed. First of all, it suggests that a fundamental solution to the recession would encourage labor supply (perhaps cutting personal income tax rates, so people can keep more of their wages), rather than tinker with demand.

Second, the recent supply reduction may be more short-lived than the demand reductions of past severe recessions. In particular, as people adjust to the reality of depleted retirement accounts and vanished home equity, many of them will decide to make up for some of the shortfall by working more and retiring later.

And on another note, the department of economics at the University of Chicago does not conform to stereotypes: Professor Douglas ran for senator on the Democratic Party ticket and was occasionally accused of being a socialist. I teach his formula frequently and with admiration.