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The Crusade That's Killing Prosperity by Lester C. Thurow

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The great untold story of the American economy in the 1990s is the disguised high rate of unemployment and its direct impact on stagnating living standards. Properly calculated, our rate of joblessness is well into double digits. No wonder workers have no bargaining power to get their share of an increasingly productive economy.

Among economists, a debate rages on why earnings inequalities began to rise rapidly and real median wages started to fall a quarter century ago. Some blame a technological shift that cut demand for uneducated labor while boosting the demand for those with greater education and skills. Others identify global "factor price equalization"--in an open global economy overseas workers with comparable skills but lower wages are forcing the wages of Americans down.

What's left out of this lengthy, if inconclusive, debate is the role played by the slack economic environment in which these two forces have been operating. While each is real, their impacts would have been very different if they had operated in an environment of labor shortages rather than one of vast labor surplus. The U.S. economy has been celebrated for creating tens of millions of jobs during the past two decades. But properly counted, our true unemployment rate is no better than Europe's. And nothing keeps wages from rising like a large pool of idle or underemployed workers.

Today's slack labor markets were produced by the war against inflation--declared in the early 1970s and still underway 25 years later. Inflation began with the mis-financing of the Vietnam War in the late 1960s, accelerated with the OPEC oil shock and food shocks of the early 1970s, expanded across the economy in the mid-1970s because of the widespread use of cost-of-living indexes in both labor and supplier contracts, and was rekindled by the second OPEC oil shock at the end of the 1970s.

While other remedies such as wage and price controls were initially tried, none seemed to work. Eventually all of the world's major governments came to the conclusion that the only cure for inflation was to use higher interest rates and tighter fiscal policies (higher taxes or lower expenditures) to restrain prices by deliberately slowing growth to push unemployment up and to force real wages down. Excess capacity and surplus labor became the key players in the anti-inflationary game.

In the end the strategy for braking the world economy worked. The world's real economic growth rate slid from 5 percent per year in the 1960s to 3.6 percent per year in the 1970s. The double-digit inflation of the early 1980s led to another round of monetary tightening, and growth further decelerated to 2.8 percent per year in the 1980s. Actions such as Federal Reserve Chairman Alan Greenspan's seven interest rate hikes between early 1994 and early 1995 and the Bundesbank's very restrictive policies in Germany slowed the world's growth rate even further, and in the first half of the 1990s world growth has averaged just 2 percent per year. Today the Federal Reserve Board designs policies to limit American economic growth to a maximum of 2.5 percent or less. Anything more is believed to be inflationary. In its annual policy recommendations, the Organization for Economic Cooperation and Development (OECD) subscribed to the view that America's maximum noninflationary growth rate was 2.5 percent.

Like a real war that has gone on far too long, all of the original reasons for the war--the mis-financing of the Vietnam War, OPEC oil shocks, food shocks, indexed wage and supply contracts, inflationary ex pecta tions--are long gone. As the war continues year after year, the negative side effects of the war, falling real wages and rising inequalities, have become far more corrosive than the original reasons for joining the battle. The battle continues even though the war against inflation has been won. The combatants have gotten so used to "fighting on" that they cannot even recognize that they have won.

Slow growth cured inflation because it directly pushed real wages down--creating very slack labor markets. Indirectly, it created an environment where factor price equalization, a skill-intensive technological shift, and other factors could generate enormous downward pressures on real wages.

Restrictive monetary and fiscal policies have produced unemployment rates not seen since the Great Depression. Today, more than 10 percent of the European workforce is officially unemployed and in three countries (Spain, Ireland, and Finland) unemployment has been above 20 percent at some point in the first half of the 1990s. Spain and Italy have youth unemployment rates of over 60 percent. While it is very fashionable to blame Europe's high unemployment rates on "rigid labor markets," which is to say unions and welfare state protections, the real culprit is macroeconomic austerity. Most of the same protections existed before 1973, and coexisted nicely with high growth, full employment, and rising wages. Japan's official unemployment rate is near 3 percent, but Japan essentially has a system of private unemployment insurance where workers who would be fired in the United States remain on private payrolls. Even the Japanese admit that if their firms acted as American firms do, their unemployment rate would be over 10 percent.

THE REAL UNEMPLOYMENT RATE

In the fall of 1995, America's official unemployment rate was hovering around 5.7 percent. But like an iceberg that is mostly invisible below the waterline, officially unemployed workers are just a small part of the total number of workers looking for more work.

If we combine the 7.5 to 8 million officially unemployed workers, the 5 to 6 million people who are not working but who do not meet any of the tests for being active in the workforce and are therefore not considered unemployed, and the 4.5 million part-time workers who would like full-time work, there are 17 to 18.5 million Americans looking for more work. This brings the real unemployment rate to almost 14 percent.

Slow growth has also generated an enormous contingent workforce of underemployed people. There are 8.1 million American workers in temporary jobs, 2 million who work "on call," and 8.3 million self-employed "independent contractors" (many of whom are downsized professionals who have very few clients but call themselves self-employed consultants because they are too proud to admit that they are unemployed). Most of these more than 18 million people are also looking for more work and better jobs. Together these contingent workers account for another 14 percent of the workforce. In the words of Fortune magazine, "Upward pressure on wages is nil because so many of the employed are these `contingent' workers who have no bargaining power with employers, and payroll workers realize they must swim in the same Darwinian ocean." Like the unemployed, these contingent workers generate downward wage pressures.

In addition there are 5.8 million missing males (another 4 percent of the workforce) 25 to 60 years of age. They exist in our census statistics but not in our labor statistics. They have no obvious means of economic support. They are the right age to be in the workforce, were once in the workforce, are not in school, and are not old enough to have retired. They show up in neither employment nor unemployment statistics. They have either been dropped from, or have dropped out of, the normal working economy. Some we know as the homeless; others have disappeared into the underground illegal economy.

Put these three groups together and in the aggregate about one-third of the American workforce is potentially looking for more work than they now have. Add in another 11 million immigrants (legal and illegal) who entered the United States from 1980 to 1993 to search for more work and higher wages, and one has a sea of unemployed workers, underemployed workers, and newcomers looking for work.

These millions of job-hunters lead to a more human-scale result that everyone can understand. At 5 p.m. a midsized metal-ceramic firm posts job openings for 10 entry-level jobs on its bulletin board. By 5 a.m. 2,000 people are waiting in line to apply for those 10 jobs.

WHY WAGES FALL

While the economy has been generating about 2 million jobs per year since the end of the 1990-1991 recession, these gains are just barely large enough to hold even with migration and the normal internal rate of growth of the working-age population. However rapid, job growth cannot lead to wage increase, unless it is faster than the growth rate of those looking for work.

If one believes even marginally in the power of supply and demand, surplus labor of these magnitudes has to lead to falling real wages. Wages rise roughly with productivity growth only if there are labor shortages. Since slow growth throws the bottom 60 percent of the workforce into unemployment far more than it does the top 20 percent, the earnings of the bottom 60 percent should be expected to fall sharply relative to the top 20 percent in a period of high unemployment--as they have.

These direct negative effects on wages were compounded by several indirect effects. American economists used to talk about something called "efficiency wages." One of the mysteries of the post-World War II era was wages that rose even when there were unemployed qualified American workers who would have been glad to do those jobs for less. This anomaly was explained by arguing that firms deliberately paid incumbent workers above-market wages to secure a high degree of cooperation, commitment, and effort that they could not have gotten if their workforces could have quit and easily gotten equal wages elsewhere.

But in a world where there are always millions of unemployed and underemployed workers, firms do not have to pay efficiency wages. The same degree of cooperation, commitment, and effort can be achieved by using the motivation factor called "fear"--the fear of being thrown into this enormous sea of unemployment and underemployment. In the last five years examples abound of profitable firms that simply marched in and dramatically lowered the wages of their existing workforces by 20 to 40 percent. Workers complain but they don't quit.

Similarly, two decades of surplus labor have broken the linkage between productivity gains and wage increases. The early 1990s demonstrated that no government would come running to the rescue with large fiscal and monetary packages designed to stimulate demand during recessions. Instead, recessions would be allowed to run their course and governments would simply wait for a recovery--or as happened in 1994 in the United States, adopt monetary policies to actually slow what was already by historical standards a very weak recovery.

Knowledge that governments won't shorten recessions radically changes expectations. If downturns are sharper and longer, business firms have to reduce prices if they wish to survive. As a result, in the 1990s more of America's productivity gains are showing up as falling prices and fewer are showing up as rising wages. Higher labor productivity doesn't lead to higher labor wages as it used to. Wages can fall while productivity rises--as has happened in the last 20 years.

The best example is the computer industry--an industry that pays very low wages for its production workers. Productivity is growing very rapidly, but all of that productivity gain shows up in lower prices or higher profits for chip-makers or software firms. None shows up as higher wages as used to occur in industries such as automobiles or steel. This sea of excess labor accentuates the downward pressures of a skill-intensive technology shift and global factor price equalization. Tight labor markets would offset much if not all of the impact on the bottom 60 percent of the wage distribution, but they don't exist.

A skill-intensive technological shift should raise the wages of the skilled and lower the wages of the unskilled, but in the context of vast supplies of excess labor the expected higher wages even for skilled workers don't appear. The upward wage pressures that should be seen are more than offset by the downward pressures from surplus unemployed skilled laborers. For males, real wages are now falling at all education levels, even for those with graduate degrees. For the unskilled the downward wage pressures that flow from this technological shift are magnified because of the surplus labor that already exists.

The war on inflation has also intensified the downward wage pressures coming from a number of other sources. Some capitalists certainly plotted to kill America's labor unions. President Reagan's firing of all of America's unionized air traffic controllers legitimized a deliberate strategy of de-unionization. In the private sector, consultants were hired who specialized in getting rid of unions, decertification elections were forced, and legal requirements to respect union rights were simply ignored--firms simply paid the small fines that labor law violations brought and continued to violate the law. The strategy succeeded in shrinking union membership to slightly more than 10 percent of the private workforce (15 percent of the total workforce). And even where unions still existed they lost much of their power to influence wages or negotiate working conditions. Combined with corporate compensation committees who in the past 25 years have escalated CEO salaries from 35 to 157 times that of entry-level workers, one could argue that the capitalists had declared class warfare on labor--and were winning.

While the economics literature is inconclusive as to whether unions affect average wages (equally productive companies with and without unions tended to pay the same wages in the past), there is no doubt that unions affect the distribution of wages. Wage distributions are much more equal where unions exist. High school-college wage differentials, for example, have always been smaller in the union sector than in the nonunion sector. As a result, with the demise of unions as a force in the American economy, wage differentials should be expected to rise. In addition, as company worries about unionization have waned, the gap between union and nonunion wages has doubled. Higher wages no longer need to be paid in nonunion firms to keep unions out.

The attack on unions could not have succeeded in an environment of tight labor markets. But in this sea of surplus labor, unions have little negotiating power to offer prospective members.

Deregulation has also led to some wage reductions. In regulated industries such as trucking and airlines, workers collected some of the excess profits--what economists call "rents"--that accrued from regulation. Truck driver wages and the wages of some airline employees fell dramatically with deregulation. In the case of truck drivers, wages fell three times as fast as elsewhere. The rents that had been built into their wages were transferred back to the consumer or to corporate profits. But in a world of tight labor markets more of those rents would have stayed with workers.

Since wages in the many advanced industrial countries are now above those in the U.S., most of the factor price equalization flowing from other First World countries is behind us. But ahead lies the integration of the Second World into the First World and a very different Third World. The communist countries did not run effective civilian economies but they ran excellent education systems. The Soviet Union was a high-science society with more engineers and scientists than anyone other than the United States. China is capable of quickly generating hundreds of millions of medium-skill workers. The end of communism and the success of the "little tiger" countries on the Pacific Rim have led the Third World to junk import substitution as a route to economic development, and to become export oriented. Where countries with only a few million workers used to be export oriented (Singapore, Hong Kong, Taiwan, and South Korea), Third World countries containing billions of people now want to be export oriented (Indonesia, India, Pakistan, Mexico). As a result, exports from low-wage Third World countries are apt to be much larger in the years ahead. Whatever one believes about how much of real wage declines and increases in wage dispersion can be blamed on globalization in the past, the forces of factor price equalization are going to grow enormously. If they continue to operate in a world of slack labor markets inside the United States, the rate of decline in real wages will accelerate.

THE REAL INFLATION RATE

Inflation itself has already ended. But as long as the policymakers are convinced that the ghost of inflation will at any minute reappear, they will operate their policies as if inflation were a real threat.

It is possible, in fact, that inflation is even lower than its low official rate. The broadest measure of inflation, the implicit price deflator for the gross domestic product, fell from 2.2 percent in 1993 to 2.1 percent in 1994, and in the third quarter of 1995 inflation was running at the rate of 0.6 percent.

Having fallen during the previous recession, the producer's price index for finished consumer goods in December 1994 was below where it had been in April 1993 and annual rates of increase decelerated from 1.2 percent in 1993 to 0.6 percent in 1994. In 1994 and 1995 labor costs rose at the slowest rate since records had been kept and the core rate of inflation (the rate of inflation leaving out volatile energy and food prices) was the lowest rate recorded since 1965.

Officially the rate of inflation in the consumer price index (CPI) fell from 3 percent in 1993 to 2.6 percent in 1994, and to 2.5 percent in 1995, but Chairman Greenspan had himself testified to Congress that the CPI exaggerated inflation by as much as 1.5 percentage points since it underestimated quality improvements in goods (in computers, for example, it has performance rising at only 7 percent per year) and since it gives no credit at all for quality improvements in services. The Boskin Commission, appointed by the Senate Finance Committee, has estimated the upward bias in the CPI at between 1 and 2.4 percentage points. If one is willing to assume that the sectors where quality improvements are hard to measure are in fact improving quality at the same pace as those sectors where quality is easy to measure, the over-measurement of inflation may be closer to 3 percentage points.

Health care is a sector whose inflationary dynamics have little to do with macroeconomic pressures. Since health care accounts for 15 percent of GDP and health care prices were rising at a 5 percent annual rate in 1994, mathematically another 0.75 percentage points of inflation can be traced to health care (more than one-third of 1994's total inflation).

Put all of these factors together and it is clear that the rate of inflation in the sectors where inflation is controllable with slower growth is certainly very low and probably actually negative. While some economists argue that the CPI does not in fact overstate inflation [see Dean Baker, "The Inflated Case Against the CPI," TAP, Winter 1996] it is bizarre that Alan Greenspan is among those who think that inflation is significantly below its officially measured rate since it undercuts his arguments for contractionary monetary policy.

Left to their own devices, those who operate central banks are never going to declare a permanent victory over inflation. The reasons are simple. If the battle against inflation is primary, central bankers will be described as, and actually be, the most important economic players in the game. Without inflation, they run rather unimportant institutions.

It is important to remember that in 1931 and 1932 as the United States was plunging into the Great Depression, economic advisers such as Secretary of the Treasury Andrew Mellon were arguing that nothing could be done without risking an outbreak of inflation--despite the fact that prices had fallen 23 percent from 1929 to 1932 and would fall another 4 percent in 1933. The fear of inflation was used as a club to stop the actions that should have been taken. Central banks are prone to see inflationary ghosts since they love to be ghostbusters. While it is true that no human has ever been hurt by a real ghost, it is equally true that ghostbusters have often created a lot of real human havoc.

Central bankers will of course tell us that when they gain "anti-inflationary credibility," rapid noninflationary growth will resume. But this is a mirage shimmering in the hot desert air. If any central bank has anti-inflationary credibility, it should be the German Bundesbank, yet Germany has one of the industrial world's lowest real growth rates. If the Bundesbank has not yet achieved anti-inflationary credibility, no central bank ever will obtain this exalted status.

As a result, if policies are to change it will require a change in political perceptions. Rising inequalities and falling real wages have to come to be seen as more important problems than the ghost of inflation when it comes to getting elected or reelected. Social welfare programs for the poor are not politically viable as long as the poor do not vote for the politicians who support the programs that benefit them. Tight labor markets are equally politically unviable unless voters reward the politicians who are willing to reverse the macroeconomic policies that have been in place for the past 25 years.

The long-run answer to falling wages is a much better-skilled bottom three-quarters of the American workforce, but without a reversal in our macroeconomic policies no set of human-capital investment policies can hope to work.

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