Introduction

An extraordinary event occurred in the American economy in the second half of the 1990s. For the first time in three decades, the labor market was operating at or near full employment. The purpose of this volume is to better document, understand, and learn from this achievement.

The benefits of full employment are far reaching. While many worthy social programs can improve on market outcomes, there is no better way to lift the living standards of all working families than through full employment in the labor market. In this sense, this book is a paean to the marketplace, but with an important twist: the rule that has long guided economists and the Federal Reserve in determining the specific level of the unemployment rate consistent with full employment is no longer credible. Thus, it is time to derive a new concept of full employment that relies less on the old rule—the relationship between unemployment and inflation—and more on the actual experience of the marketplace.

A more comprehensive view of full employment—one that does not simply tie it to stable prices—would define it as the level of employment at which additional demand in the economy will not create more employment. It is reasonable to argue that we were approaching this level in 2000, when the unemployment rate averaged 4.0%. By contrast, most economists, including influential policy makers, had worried that, if unemployment fell to the levels reached in the late 1990s and 2000, inflation would start to increase and would keep increasing until unemployment rose again. This belief was in part responsible for preventing the achievement of full employment sooner. Even now, after half a decade of tight labor markets and little evidence of accelerating inflation, the notion that low unemployment threatens to trigger runaway inflation still pervades the thinking of policy makers, economists, and the media.

For example, despite the fact that unemployment fell to 3.9% in the fall of 2000, and did so in a non-inflationary climate, the influential Congressional Budget Office still forecasts a long-term unemployment rate of 5.2%. In June 2001, when demand began to weaken and unemployment

had risen to 4.4%, a *New York Times* editorial noted that "[u]nemployment… is still well below the rate commonly associated with stable inflation and growth." Apparently, the long, sustained period of low unemployment, low inflation, and strong wage growth throughout the wage scale, not just at the top, was insufficient to shake the belief that the unemployment rate needs to be at or near 6%. Policy rules that maintain this notion serve the nation badly by needlessly sacrificing hundreds of billions of dollars of output and keeping unemployment too high. What's more, experience over the 1980s and early 1990s revealed that this thinking leads to stagnant living standards or worse among the bottom half of working families.

This is not to deny a relationship between unemployment and price pressure. But there is a huge difference in acknowledging this relationship and believing that unemployment below a certain percentage point necessarily leads not just to an uptick in inflation but to *accelerating* inflation, as postulated in the theory of the non-accelerating inflation rate of unemployment (NAIRU) .

As the experience of the late 1990s showed, the benefits of full employment are far reaching throughout the economy, for workers as well as for their managers, for labor and government as well as for business, and they far outweigh any risks of price pressure. For example, full employment in the 1990s helped to reverse the long-term decline of the real wages of many workers, particularly those at the lower end of the wage scale, as well as the stagnation in wages for higher-paid white-collar workers. Moreover, the seemingly inexorable increase in inequality slowed in the late 1990s, as the incomes of workers at the bottom grew more quickly than those of workers in the middle of the income scale. Other important though less well-known trends also responded positively to full employment. One way to characterize these is with respect to job quality. The tautness of the labor market meant that, in order to hire and retain even low-wage workers, more employers had to offer health and pension benefits than would have been the case had weaker demand for labor prevailed. Also, when the labor market tightened enough, the share of so-called involuntary part-timers, i.e., those employed part time but seeking full-time jobs, declined. In addition, there was fall in the number of discouraged workers, persons who want a job but have given up searching for one due to pessimism about their prospects. (Note that these persons are not counted in the unemployment rate, which measures only those actively seeking work.)

The tight labor market also pulled more people in, including those pushed from public assistance with the implementation of welfare reform. Critics of welfare reform predicted that, in the absence of a surge in demand for low-wage labor, the policy would lead to high levels of jobless-

ness among welfare leavers, depressed wages among other low-wage workers, or, most likely, some combination of both. In fact, labor demand surged, and the tight labor market pulled in many disadvantaged workers who were left behind when the unemployment rate was closer to 6%.

The strong growth and low unemployment of the late 1990s caught virtually everyone by surprise. Analysts have pointed to a variety of factors to explain this prosperity, including the arrival of federal budget surpluses, the post-1995 surge in productivity, the stock market, and the run-up in the dollar.[1] One under-appreciated dimension of the boom was the contribution of full employment to the fast productivity growth of the latter 1990s. The strong growth of the late 1990s increased the demand for, and bargaining power of, low-wage workers, allowing them to gain higher wages and benefits. When stronger demand lifted their bargaining power and thus their compensation, it became unprofitable to employ these workers in the least productive jobs. Instead firms had to restructure jobs so that workers' productivity was enough to cover higher labor costs. This meant "cutting out fat" and producing more efficiently, something they could afford *not* to do in a higher unemployment environment. While it is difficult to muster a lot of evidence for this hypothesis, we think it is a compelling argument. And while we do not believe that this "full employment productivity multiplier" fully explains the upturn in productivity in the late 1990s (advances in the use of computer technology explain the lion's share of the productivity acceleration[2]), it is an important part of the explanation that should not be overlooked.

While full employment has far-reaching benefits, it certainly hasn't been responsible for all the good things that happened in the economy in the late 1990s, nor has it been a panacea. A few years of low unemployment cannot be expected to solve every problem in the economy, much less society. For one, the economy had operated below full employment for so long that many of the beneficiaries of the boom were digging out of very deep holes. Also, not everybody benefited. Various groups of disadvantaged workers, such as young, less-skilled, African American men, did not do nearly as well as others.[3] Low unemployment by itself cannot address all the inequities in society. Other forms of intervention are still needed to assist disadvantaged populations.

Yet full employment—at most, a 4% unemployment rate—must be a central policy goal of political and economic institutions. The 1990s boom turned to bust in 2001, and its eventual end was to be expected. After all, there was no reason to believe that the business cycle had been eradicated from the American economic landscape, and the boom was partially driven by speculative bubbles that have in part deflated. In 2001 when unem-

ployment rose to 4.8%, still below what most economists consider to be consistent with stable prices (and thus "too low"), real household incomes fell by 2.9% among the lowest-income households, fell 1.8% among middle-income households, and rose only slightly at the very top. In other words, once we departed even slightly from full employment, in this case due to the bursting of speculative bubbles, incomes fell and did so most quickly for the least well-off. As of late 2002 the economy continued to be hampered by slow growth and to skirt the edge of a double-dip recession.

It is our hope that policy makers will appreciate the evidence we present regarding the importance of truly full employment, particularly as it applies to those in the bottom half of the income scale. Given recent abuses of corporate power, too many working Americans feel that the economic deck is stacked against them. And there is little sense of urgency among policy makers or economists to get back to the tight labor market conditions that prevailed in the latter 1990s. Yet, if we fail to do so, we can expect the problems of the 1980s—stagnant wage growth, growing inequality, stubbornly high poverty rates—to return. To settle for anything less than full employment not only squanders hundreds of billions of dollars of potential growth. It squanders the hopes and dreams of millions of working families.