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Participation rate will continue to fall

- The decline in the participation rate is almost entirely due to structural factors and there is little prospect of a rebound in the next few years. The downward trend in the participation rate actually began as far back as 2000, driven by the aging of the population, rising disability and the upward trend in post-secondary education enrolment.
- Between 2000 and 2014, the participation rate fell by 4.5% points, from 67.1% to 62.6%. The aging of the population accounted for a 1.8% point decline in the participation rate, the increase in the ineducation rate for 16 to 20 year olds also reduced the participation rate by 1.8% points, while the increase in the in-education rate for 21 to 25 year olds reduced it by an additional 0.6% points. Finally, the increase in the disability rate accounts for 1.2% points of the decline in the participation rate. All of these are long-term *structural* trends that began well before the 2008/2009 recession.
- The post-recession cyclical impact on the participation rate appears to be a muted 0.6% points. Furthermore, since none of that cyclical decline has been reversed in recent years, even as the unemployment rate has slumped and the job openings rate has jumped to a record high, it is possible that what began as a cyclical dip is also now a permanent effect.
- We are wary of making exact predictions of how the participation rate will evolve. Historically, structural trends have often faded without warning, while new structural shifts have come out of the blue as well. The aging of the population will continue to exert downard pressure on the participation rate for at least the next few years. But the drag from rising disability already appears to have waned and the upward trend in education enrollment could fade at any time. Nevertheless, **it seems safe to say that over the next few years the participation rate is more likely to fall than rise**.
- The upshot is that, with the unemployment rate very close to 5%, **the labour market really is very close to full employment**. Admittedly, the still elevated rate of involuntary part-time workers indicates that there is some slack left. Beyond that, however, there are not hordes of disillusioned job seekers just waiting to flood back into the labour force once conditions improve. **If we are right, then expect hourly wage growth to accelerate sharply next year.**

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Participation rate will continue to fall

The decline in the participation rate.¹ to a 40-year low of 62.4% in September has reignited the debate about whether the slump is structural or cyclical. We've argued before that we think the decline is mostly structural and we're even more convinced of that now.². The aging of the population, rising disability and the expansion of post-secondary education explain most of the shift, which actually began as far back as 2000.

The participation rate has been trending lower for the past 15 years, since it peaked at 67.3% in early 2000. (See Chart 1.) Admittedly, the rate did fall at a faster pace during the recession in 2008 and 2009, suggesting that there might have been an additional cyclical element at work. But it is notable that, even with the job openings rate at a record high and the unemployment rate within touching distance of the long-run natural rate, the participation rate continues to trend relentlessly lower. If these disillusioned job seekers could be persuaded to return to the active labour force, it would already have happened.



Source – Thomson Datastream

The initial rise in the participation rate from less than 60% in 1965 to that peak of 67.3% in early 2000, is largely explained by the flow of women into the labour force. The participation rate for men has been on a very gradual downward trend since the early 1960s. (Chart 2.)



Source - Thomson Datastream

Baby Boomers reaching retirement age

The surge in the participation rate that began in the 1960s was also partly due to the echo effect of the Baby Boomers, which is the name given to those born during the spike in the birth rate between 1946 and 1965. The earliest wave of that population cohort reached employment age in the mid-1960s. 50 years later, however, that hump in the population is reaching retirement age. Women born in 1950 became eligible to retire in 2010, men became eligible to retire in 2015.



Sources – Atlanta Fed, BLS

Chart 3 shows how the age distribution of the population has changed over the past 15 years since the participation rate peaked. In 2000, the largest

² See our *US Economics Focus* "Drop in participation rate more structural than cyclical", sent to clients on 8th November 2013.

¹ The proportion of the population in the active labour force (either in work or actively looking for work).



cohort was aged between 40 and 45 (i.e. those born between 1955 and 1960). Now that same cohort is aged between 55 and 60.

The over 60s now account for 24% of the adult population, up from 20% in 2000. That increase may seem modest, but it is crucial because the participation rate drops off so dramatically around the age of retirement. For those aged between 55 and 59 the participation rate is still as high as 77.7%, but that rate falls dramatically to 55.2% for those aged between 60 and 64 (i.e. when women have retired) and to only 32.1% for those aged between 65 and 69 (i.e. when most men have retired too.) (See Chart 4.)



Source – Thomson Datastream

Younger people spend more time in education

In general, for any particular age group, the participation rate has been fairly stable over the past 15 years. (See Chart 5.) The only major change is the sharp drop off in the participation rate of younger workers, who are increasingly staying in secondary and post-secondary education for longer. Like the impact of the aging population, however, this is also a long-term structural shift that began decades ago. It is *not* a cyclical response to the weak post-financial crisis labour market.



Sources – Atlanta Fed, BLS

The participation rate for 16 to 24 year olds peaked at 68% in the early 1990s and fell sharply for the next two decades. Nevertheless, it finally appears to have stabilised at around 55% and has remained broadly unchanged at that level since early 2009. (See Chart 6.)



Source - Thomson Datastream

The Atlanta Fed labour force dynamics data, compiled from the basic level current population survey ³, shows that the decline in the participation rate of 16 to 20 year olds is mostly because those people are now in school or training instead. (The basic level current population survey includes data on why people are not participating in the labour force.) As the participation rate for 16 to 20 year olds has fallen from 55% in 1998 to 35% in 2014, the proportion saying that they were in school has risen from 30% to 55%. (See Chart 7.) As the chart makes clear, however, that decline is a long-term

³ See <u>https://www.frbatlanta.org/chcs/LaborForceParticipation.aspx</u>



structural trend that began well before the financial crisis in 2008.



Sources – Atlanta Fed, BLS

The same is true of the next youngest age cohort too. Although the 21 to 25 year old cohort has a much higher participation rate, the long-term decline in the former is fully explained by the increase in the latter. (See Chart 8.)





Sources – Atlanta Fed, BLS

Rise in disability is also structural

A third factor explaining the decline in the overall participation rate is the rise in disability. Again, however, this is a long-term structural shift rather than a post-2008 cyclical change. As Chart 9 shows, the proportion of the adult population receiving Federal disability benefits had been steadily rising since the early 1990s. But that upward trend has actually flattened out in the past couple of years. The upshot is that, while rising disability helps to explain the downward trend in the participation rate in the 12 years after 2000, it is

not an explanation for the continuing decline in the participation rate since 2012.





The added complication is that the rise in disability is partly linked to the aging of the population. Using the same current population survey data compiled by the Atlanta Fed, Chart 10 shows disability rates by age in both 2000 and 2014. Disability rates are much higher for people aged between 50 and 65 and that disparity has increased over the past 14 years. Even so, it is still worth treating disability as a separate factor, since Chart 10 shows that disability rates have increased for nearly all age cohorts.



Sources – Atlanta Fed, BLS

The steady rise in the number of Federal disability benefit recipients suggests this is a long-term *structural* change. As Chart 11 shows, for older prime-age workers who have the highest disability rates, those rates have been on a steady upward path for nearly 20 years. The 2008 recession had little, if any, impact on those trends.





Sources – Atlanta Fed, BLS

Cyclical decline a small part of the story

Beyond the impact of the three structural factors aging, education and disability - there has been a cyclical decline in the participation rate since 2008. But our calculations suggest it has been modest. The current population survey also tracks those who are outside the labour force because they don't meet the official definition of unemployed, but nonetheless say they want a job. As Chart 12 shows, for all the age groups within the prime-age range, the rate for "want a job but not in the labour force" remained unchanged between 2000 and 2007. As we would have expected, however, between 2007 and 2010 that rate then increased across all age groups. But the increase was, on average across all age groups, a modest 0.6%, suggesting that the cyclical impact was fairly small.

Interestingly, even though the unemployment rate has almost halved since 2010, the cyclical impact doesn't appear to have waned. That could mean that what started out as a cyclical impact is evolving into an additional structural factor. The long-term jobless have now been out of the workplace for so long that their skills have atrophied, making them that much harder to re-employ. This is known in economics as a hysterisis effect.



Quantifying structural versus cyclical

Table 1 provides a summary of the quantitative impact of our three structural factors and the cyclical effect⁴. Between 2000 and 2014, the participation rate fell by 4.5% points, from 67.1% to 62.6%. The aging of the population accounted for a 1.8% point decline in the participation rate, the increase in the in education rate for 16 to 20 year olds also reduced the participation rate by 1.8% points, while the increase in the in education rate for 21 to 25 year olds reduced it by an additional 0.6% points. Finally, the increase in the disability rate accounts for 1.2% points of the decline in the participation rate.

TABLE 1: % POINT CHANGE IN PARTICIPATION RATE BETWEEN 2000 & 2014

	% Point Contribution
Total	-4.5
Including:-	
Aging of the Population	-1.8
Increase in Education Rate For 16-20 Year Olds	-1.8
Increase in Education Rate For 21-25 Year Olds	-0.6
Increase in Disability Rates	-1.2
Cyclical	-0.6
Other	+1.5
Sources – Atlanta Fed, BLS, CE	

disability was estimated by calculating the participation rate using fixed disability rates for 2000. The cyclical impact was estimated using changes in respondents who wanted a job but weren't in the active labour force.

⁴ The impact of aging was estimated by calculating the participation rate if the age distribution of the population had remained unchanged at 2000 levels. The impact of the shift into education was estimated by adding changes in education rates to the participation rate for younger workers. The impact of



The impact of aging, education and disability has increased gradually over the past 15 years. (See Chart 13.) In particular, the 2008/2009 recession doesn't appear to have altered those long-term trends, which is why we are confident that they are structural shifts, which won't be reversed over the next few years.



Sources – Atlanta Fed, BLS, CE

The post-recession cyclical impact on the participation rate appears to be a muted 0.6% points. Nevertheless, as we noted above, the fact that the cyclical impact hasn't declined over the past five years could mean that this is now a permanent effect too.

Together, our three structural factors and the cyclical shift more than explain the 4.5% point decline in the participation rate. The upshot is that some combination of other factors must have been putting upward pressure on the participation rate since 2000, resulting in an increase of around 1.5% points. The most likely explanation for this is the rise in the participation rates of older workers⁵.

The participation rate for those aged 55 plus increased from 32% in 2000 to 40% in 2009. (See Chart 14.) Note, however, that rapid upward trend in the participation rate for older workers appears to have come to an abrupt end around 2009. Accordingly, this isn't a reason to believe that the participation rate will rise over the next few years.



Conclusions & outlook for the participation rate Our analysis suggests that nearly all of the decline in the participation rate is structural. Of the 4.5% point fall in that rate since 2000, only 0.6% points is a post-2008 cyclical decline.

Accordingly, it seems unlikely that we will see any meaningful rebound in the participation rate over the next few years. We are very wary of making exact predictions of how the participation rate will evolve, however. Historically, structural trends have often faded without warning, while new structural shifts have come out of the blue as well. The aging of the population will continue to exert downard pressure on the participation rate for at least the next few years. But the drag from rising disability already appears to have waned and the upward trend in education enrollment could fade at any time. Nevertheless, it seems safe to say that over the next few years the participation rate is more likely to fall than rise.

The upshot is that, with the unemployment rate close to 5%, the labour market really is approaching full employment. Admittedly, the elevated rate of involuntary part-time workers indicates that there is still a little slack left. Beyond that, however, there are not hordes of disillusioned job seekers just waiting to surge back into the labour force once conditions improve. If we are right, then expect hourly wage growth to accelerate sharply next year.

⁵ Even though the participation rate for those older people has risen it is still significantly lower than the participation rate for prime-age workers.