SPECIAL REPORT

TD Economics

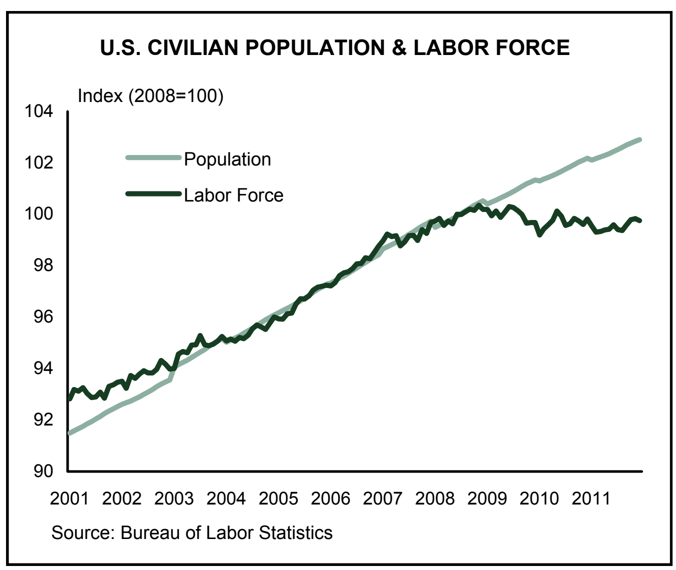
January 26, 2012

THE WORRISOME DECLINE IN THE U.S. PARTICIPATION RATE

Highlights

- The U.S. participation rate has declined significantly over the last few years, dragging the U.S. the labor force down by close to a million people. The recent recession shoulders much of the blame for the declining participation rate, but structural forces are also at play that could make it permanent.
- The people most likely to see a rebound in participation are core working-age people between 25 and 54 years old. However, discouraged workers appear unlikely to return to the workforce quickly. Several sectors in the U.S. remain structurally impaired, and for people who have been out of work for several years, the potential to come back into the workforce is limited.
- At a minimum the U.S. labor force should be expected to turn from negative to positive growth over the next year, which means that increases in employment will have to take the full load of reducing the unemployment rate. The recent declines in the unemployment rate seen over the last year due to a reduction in the labor force are unlikely to continue.
- In the medium-term, removing the structural forces that are impeding a recovery in the labor force will be fundamental to restoring U.S. economic growth to its full potential.

The U.S. unemployment rate has declined sharply over the last year, falling from 9.4% to 8.5%. This fall has been steeper than most economists – ourselves included – had expected. Unfortunately, our forecast miss was not because we underestimated the strength in the economy, but instead because of a rise in the number of people who have stopped searching for work altogether. However, while the decline in labor force participation has meant a faster decline in the unemployment rate, this is not a good news story. Growth in the labor force is a primary determinant of the potential growth rate of the U.S. economy. A declining labor force represents nothing short of a loss of economic potential.



As the job market continues to recover, the natural assumption would be that discouraged workers will return to the labor force and the participation rate will rebound. However, dissecting the participation rate by age categories reveals that "less temporary" factors are also at play. In particular, rising school enrollment has likely led to lower participation among 16-24 year olds. At the other end of the age spectrum, aging baby boomers will also put downward pressure on the participation rate.

The best hope for a rebound in the participation rate lies with core working age people (25-54). However, historical experience suggests that this will not occur swiftly and will likely require a

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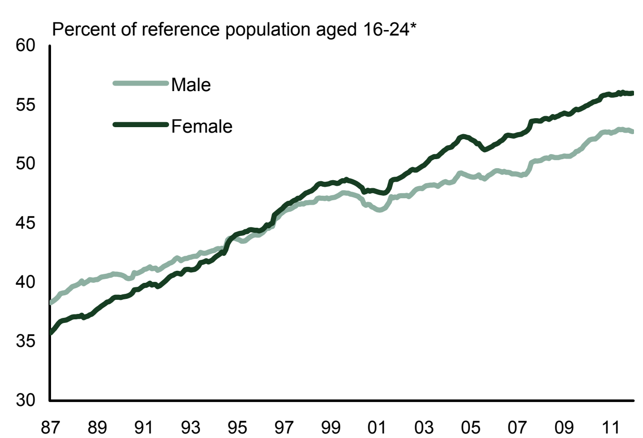
much faster pace of job growth than is currently anticipated. Moreover, structural impairment in a number of U.S. sectors alongside an unprecedented increase in the duration of unemployment have made it even more difficult for people who have left the job market to quickly return to it. All told, as long as the economy remains structurally impaired, there is reason to be careful about how fast discouraged workers will move back into the workforce, even as job growth continues.

Hi-ho hi-ho it's off to school we go

Young people have seen the biggest change in participation rates over the last several years. Since the start of the recession, the percentage of people aged 16-24 participating in the workforce has declined from 61% to just over 55%. While a sour job market accelerated the fall, young people's participation rates had been declining well before the recession. In fact, the overall participation rate of 16-24 year olds peaked in 1989. Had it not been for female entry into the workforce it would have peaked even earlier – the participation rate for males aged 16-24 peaked in 1949.

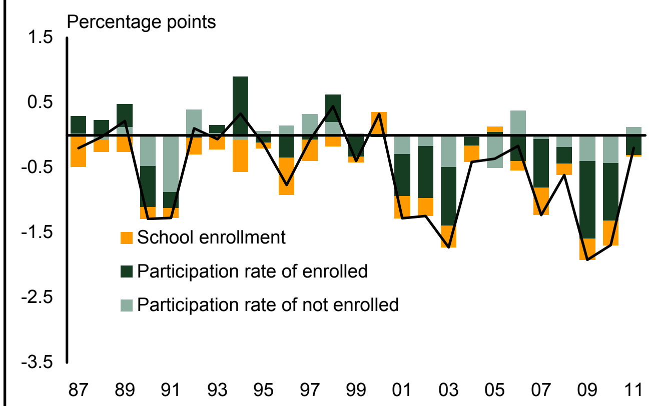
Two main factors explain the secular decline in young people's participation rates: increased school enrollment and declining labor force participation rates among students in high school and college. Since 1985 (the first year data is available), the share of young people enrolled in school has risen by 18 percentage points. Enrollment in school does not exclude a person from participating in the labor market, but the enrolled have a much lower participation rate. In fact, from 1985 to 2000, the fall in the participation rate of 16-24 year olds was due entirely to rising enrollment.

ENROLLED IN SCHOOL



*12 month moving average of NSA data. Source: BLS

CONTRIBUTION TO CHANGE IN PARTICIPATION RATE OF 16-24 YEAR OLDS

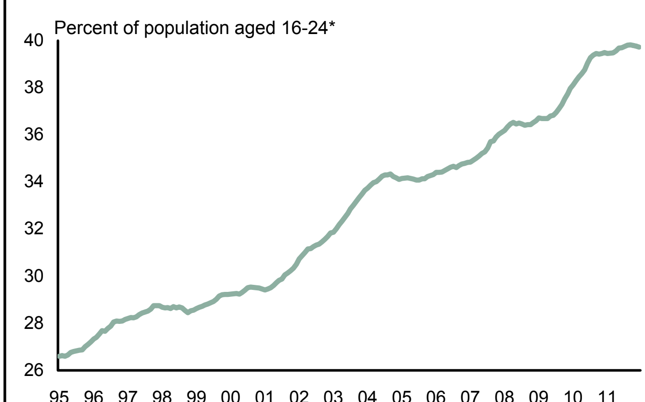


Source: BLS, TD Economics

In the early 2000s, the decline in the youth participation rate accelerated and its core driver changed. While school enrollment continued to rise, the main contributor to falling labor force participation became a decrease in labor force attachment among students. In particular, between 2000 and 2011, the participation rate of students enrolled in high school fell by a whopping 19 percentage points, accounting for over 70% of the decline in the enrolled participation rate over this time.

Given the relatively long-run nature of the decline in youth participation, it seems unlikely that it will rebound swiftly, even as the job market recovers. Indeed, the vast majority of youth who are not participating in the workforce have no desire to get a job. Since 2001, the share of 16-24 year olds who do not want a job has risen relatively consistently.

16-24 YEAR OLDS WHO DO NOT WANT A JOB NOW



*12 month moving average of NSA data. Source: BLS

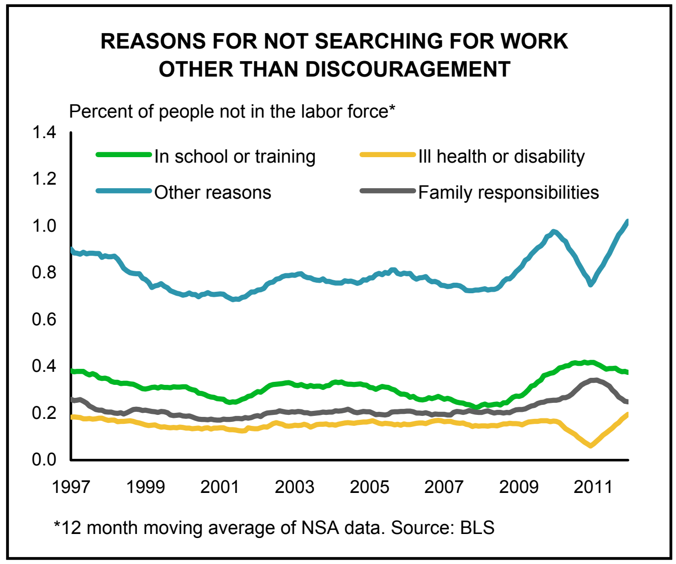
While lower youth participation would in itself temper economic potential, the upside is that in the longer-run, higher labor productivity, as a result of increased education levels, will provide an offset. Given the steady increase in the percentage of the population with advanced degrees, this is one area where there is a case for optimism.

Discouraged or out for good?

The biggest rebound potential in the participation rate over the next several years lies within the core working-age population. Over the last three years, the participation rate of people in their core working years – 25 to 54 – has fallen from 83.1% to 81.6%, a decrease of 1.5 percentage points (and equivalent to 1.8 million people).

Participation rates among core working age people do appear to be influenced by the business cycle. This can be seen more clearly by removing the longer-run trend from the participation rate and looking at differences from this trend (see chart below). Just as in the past recession, the "cycle" component of the participation rate appears to fall even in the early stages of economic recoveries and does not appear to rebound until four to five years into a new business cycle. During the 1990s, the participation rate was below trend until mid-1996, while following the 2001 recession, it remained below trend until 2006. Based on historical experience, it may take several years of relatively robust job growth before the participation rate for this crucial age cohort sees a significant rebound.

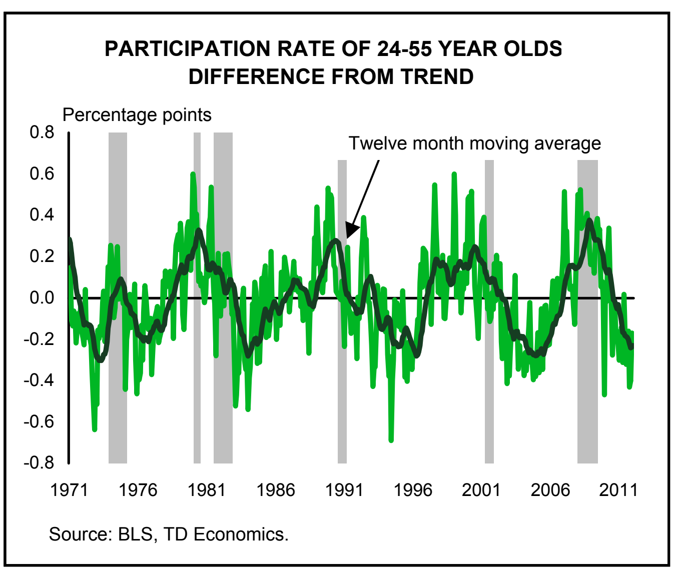
Indeed, the nature of the current recession and recovery could provide an even longer period of time before the core participation rate rebounds. In the early stages of the

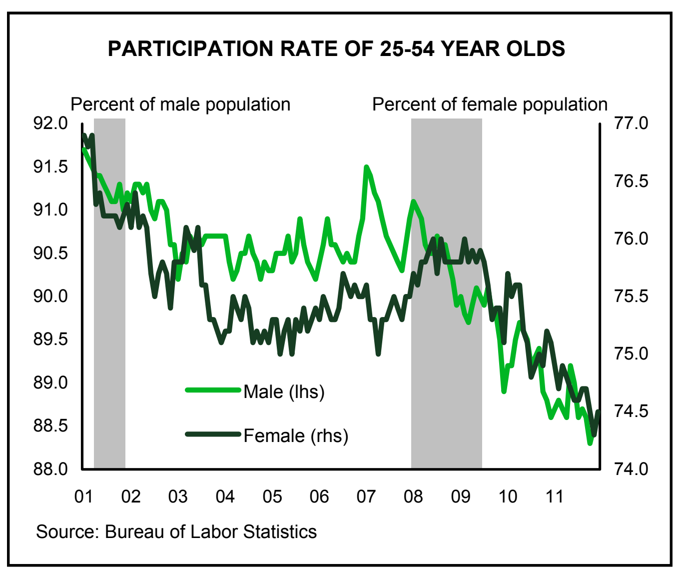


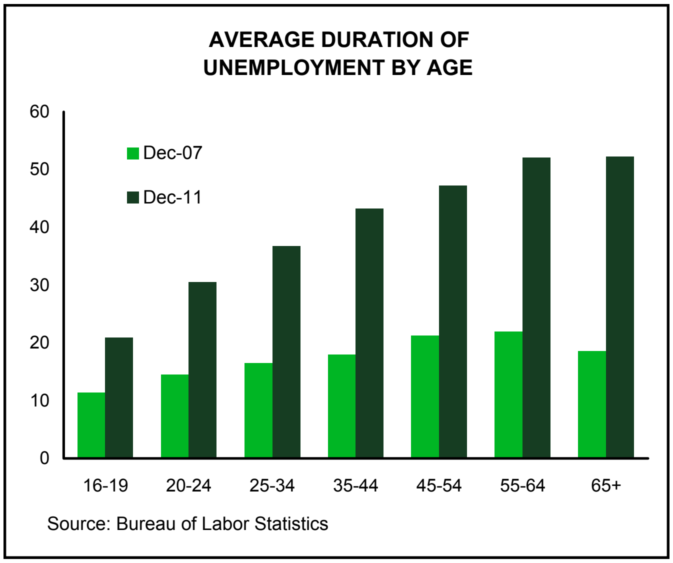
recession, the decline in the participation rate was made up entirely of men. Over the last two years, however, females have also been increasingly leaving the workforce. In 2011, the female labor force participation rate fell by 0.6 percentage points, the same decline as males.

For men, the earlier decline is consistent with a fall in construction activity – where men make up 87% of employment. For women, the later decline may reflect the fact that structural impairment has now moved to sectors where women play a bigger role. One of the very worst performing sectors in terms of employment in 2011 was state and local government where women make up 60% of employment.

Another factor that tempers expectations for a near-term rebound in the participation rate is a decline in the number of discouraged workers in 2011. Unfortunately, the fall was







not due to movement back into the labor force, but instead reflected an increase in people who are not currently looking for work for "reasons other than discouragement." The biggest category to gain at the expense of discouraged workers was literally "other reasons," which includes people who simply did not provide any answer at all as to why they were not currently looking for work.

The fact that people are no longer considering themselves discouraged could signal a more permanent move away from labor force participation. The average duration of unemployment currently sits at 39.4 weeks, more than twice as high as it was prior to the recession. For people who have been out of the workforce for several years, the potential to come back into the workforce is likely severely impaired and could result in a participation rate that will take even longer to rebound than normal.

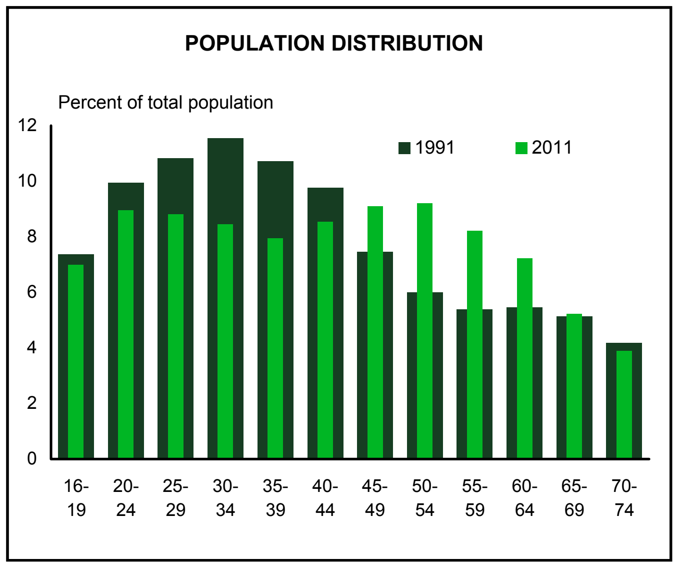
All told, while there are signs of stabilization in the participation rates of core-working age people, there are a number of reasons to be cautious about expecting a significant or swift rebound.

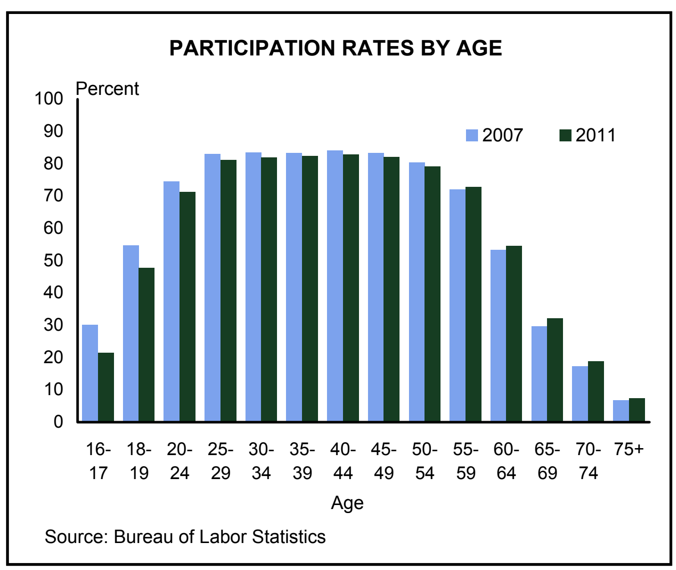
Postponing retirement, but not forever

While labor force participation rates have been declining among young and middle-aged people, the same cannot be said for older workers over the age of 55. On the contrary, the participation rates of both men and women over 55 years old continued to rise through the recession and only showed signs of slowing down in the last year and a half.

Much like the decline in the participation rate of younger people, the increase in participation rates of older workers is a trend that had been in place well before the recession. Indeed, it has mirrored another, longer-term trend – the movement of the baby boomers into their pre-retirement years. In fact, over the last several years, the rise in the participation rates of older workers has only offset the downward pressure exerted by more people moving into their older years.

Population aging exerts downward pressure on participation rate because of a life-cycle pattern where participation rates peak in the early forties and then begin to decline with every older age group. While the declines are small between the 35-44 and 45-54 age categories, there is a significant drop in participation rates in people over 55 (see chart below). In 2011, even with the rise in older worker's participation, the participation rate of 25-54 year olds was more than 40

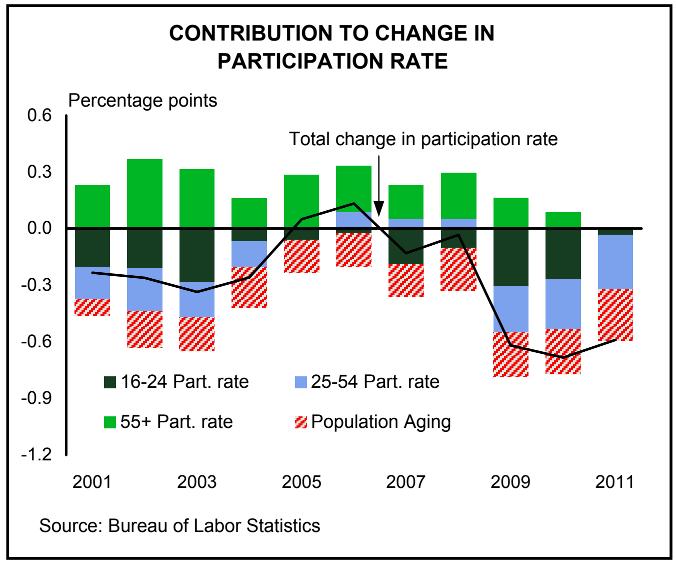




percentage points higher than people over 55. This matters because the largest age cohort in the U.S. population is currently 50 to 54 year olds.

With some relatively simple arithmetic, the change in the aggregate participation rate can be decomposed into the influence of changes in population distribution and changes in the participation rates of specific age groups. In the five years prior to 2011, increasing participation among workers over the age of 55 contributed an average of 0.2 percentage points a year to the participation rate, offsetting the decline due to population aging. In 2011, however, the labor force participation of older workers stopped rising and this contribution fell to zero.

Over the next five years, population aging will subtract a quarter of a percentage point a year from the aggregate labor force participation rate. In order to offset this, the participation rate of workers above 55 would have to rise by 0.6 percentage points a year. If, as in 2011, the rise in the participation rates of older workers slows, population aging will lead to an overall decline in the labor force participation rate.



Bottom Line

Forecasts for the unemployment rate depend not only on the number of jobs that are created, but also on growth in the U.S. labor force. While it is easy to blame the decline in the U.S. labor force over the last few years on the recession, there are both cyclical and structural forces that explain its recent movement.

At the extreme, if there is no cyclical improvement in age-specific participation rates over the next year, labor force growth will turn positive, but population aging will limit it to average growth of only 70,000 persons a month. This means that in order to bring down the unemployment rate, the economy would have to create just over 70,000 jobs a month, which is significantly less than what labor market dynamics would have suggested before the recession.

In all likelihood, however, the participation rates of the core working age population will slowly begin to rebound, allowing the aggregate participation rate to improve modestly. This will push the labor force growth up to between 120,000 and 140,000 persons a month, which is roughly where it would have been expected to be over the last several years.

In the event that participation rates of younger people rebound by more than this, the outcome in the near-term will be an unemployment rate that will be slower to move down, and one that could even move back up. However, given that labor force participation is itself dependent on the pace of job growth, a relatively tepid job growth environment means that a significant rebound in labor force participation is less likely to occur.

Of course, there is a real and significant downside to a relatively moribund participation rate. In the slightly longer-term, growth in the labor force is a primary determinant of the growth rate of the economy. The structural forces that are impeding a true recovery in the labor force will be a key challenge to restoring U.S. economic growth to its full potential.

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