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The Recent Decline in the Labor Force Participation Rate and Its Implications for Potential Labor Supply

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In lieu of an abstract, here is a brief excerpt of the content:

The Recent Decline in the Labor Force Participation Rate and Its Implications for Potential Labor Supply

Stephanie Aaronson, Bruce Fallick, Andrew Figura, Jonathan Pingle, and William Wascher

The labor force participation rate is defined as the percentage of the noninstitutional working-age population (those aged 16 and over) reporting themselves as either working or actively looking for work. This statistic is constructed from data collected as part of the Current Population Survey and published monthly by the Bureau of Labor Statistics (BLS). Its longer-run trend is an important determinant of the supply of workers to the U.S. economy. For much of the past four decades, the participation rate has trended upward, rising from less than 60 percent in the early 1960s to more than 67 percent by the late 1990s. However, after peaking at 67.3 percent in the first quarter of 2000, the participation rate fell steadily to under 66 percent by early 2005 and has edged up only to just above 66 percent since then.

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As figure 1 shows, such a decline in labor force participation is nearly unprecedented in the postwar experience. Although the upward trend between the mid-1960s and the mid-1990s was occasionally interrupted by relatively brief periods of little change, few episodes of persistent outright decline are evident in the data. Indeed, even after the upward trend from the earlier period is removed (using, for example, a Hodrick-Prescott filter **[End Page 69]** or a linear spline, not shown), the decline in the participation rate in recent years seems large and unusually protracted by historical standards.

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Figure 1.

Aggregate Labor Force Participation Rate, 1948-2005^a

A key question is whether the decline in the participation rate since 2000 primarily reflects cyclical forces-the tendency for individuals to withdraw from the labor force during periods of reduced job opportunities-or longer-

lasting structural influences. Indeed, the answer to this question bears importantly on the interpretation of recent macroeconomic developments. If the weakness in participation since 2000 is largely cyclical in nature, the current unemployment rate could be significantly understating the degree of slack in the labor market-and perhaps overstating the potential upside pressures on wage and price inflation; moreover, the outlook for longer-term economic growth would be buoyed by a higher labor force participation trend.¹ If instead much of the decline results from structural developments in the labor market, the unemployment rate may be giving the appropriate signal of current economic slack, and the implications for potential economic growth would be less favorable. **[End Page 70]**

From one standpoint the cyclical story seems quite reasonable. The downturn in the participation rate lines up closely with the weakening in overall economic activity that began in early 2001. With the exception of those over age 55, it occurred across demographic groups and coincided with a deterioration of households' perceptions of labor market conditions. Moreover, the failure of the participation rate to rebound after the 2001 recession could be a consequence of unusually weak labor demand in the subsequent recovery. However, this evidence is by no means definitive, and the persistence of a low participation rate during the recent period of more rapid employment gains has increasingly led observers to question whether other factors might be at work as well.²

This paper undertakes a comprehensive review of recent developments in labor force participation and attempts to parse the recent decline into its cyclical and structural components. After a brief overview of the data, we examine the effects of changing demographics on the aggregate participation rate and review the facts and past research on a number of other potential influences, including trends in human capital accumulation, relative wages, family structure, and income support programs. We then use a cohort-based model of the participation rate that attempts to account for these factors to estimate and project forward the underlying trend in the participation rate. Next we supplement the model-based results with analyses of recent changes in labor force participation using state-level data, gross labor force flows, and information on the incidence and duration of labor force attachment. Finally, we report briefly on...

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Board of Governors of the Federal Reserve System

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