

# Chicago Fed Letter

## Assessing the impact of job loss on workers and firms

by *Kristin F. Butcher, senior economist, and Kevin F. Hallock, associate professor, Cornell University*

Many economists agree that the United States' openness to competition and technological change raises our living standards, but sometimes results in job losses. This article summarizes "Job Loss: Causes, Consequences, and Policy Responses," a conference which was cosponsored by the Federal Reserve Bank of Chicago and the Joyce Foundation.

**According** to the U.S. Bureau of Labor Statistics, between January 2001 and December 2003, 5.3 million workers were displaced from jobs that they had held for three or more years. These workers

are of particular interest for at least four reasons. First, they may have lost their jobs through no fault of their own. Second, their long association with their employers implies that they were good employees. Third, research has demonstrated that they are unlikely to get new jobs that are similar to their old jobs—particularly if they lost their old jobs because of technological change or international trade. Fourth, research has also shown that, on average, these workers

are likely to suffer long-term earnings losses due to their job loss. These losses are larger in cases where workers had built up skills specific to a particular job and where they are unlikely to be reemployed in a similar job.

Industries and firms often have idiosyncrasies that are tied to creating their product. It is important that their workers learn specific skills for the production environment that may be unique to the firm or the industry. However, for workers, this entails risks. If the firm does not adequately compensate them for learning these job-specific skills, then they are at risk if technology changes and that job disappears. It is difficult to predict which skills will be enduringly useful and which will turn out, from the worker's perspective, to have been a bad investment. To the extent that it is beneficial to the economy overall to have workers who are willing to invest in job-, firm-, or industry-specific skills, there may be a desire to insure workers against the possibility their skills may become obsolete.

In recent years, rates of job displacement have been relatively high—as high as in earlier periods when the unemployment rate was much higher. This suggests that the pace of change in the economy may have increased the risk that workers' skills will become obsolete. It is also possible that a higher fraction of unemployed workers are those who have been displaced, who often take longer to find new jobs. This may help explain the relatively high fraction of long-term unemployment in recent years.

### 1. Policy papers associated with the conference

Henry S. Farber (Princeton), "What do we know about job loss in the United States?: Evidence from the Displaced Workers Survey, 1984–2004."

Lisa M. Lynch (Tufts), "Job loss: Bridging the research and policy discussion."

Lori G. Kletzer (University of California, Santa Cruz), "Globalization and job loss, from manufacturing to services."

Louis S. Jacobson (CNA), Robert LaLonde (University of Chicago), and Daniel Sullivan (Federal Reserve Bank of Chicago), "Is retraining displaced workers a good investment?"

Steven Redfield (STRIVE), "Understanding and addressing the challenges of job loss for low-wage workers."

Randall W. Eberts (W. E. Upjohn Institute), "After the doors close: Assisting laid-off workers to find jobs."

John A. Challenger (Challenger, Gray, and Christmas), "Return on investment of high-quality outplacement programs."

Kenneth D. Schwartz (Duviv, Cahn, and Hutton), "A lawyer's perspective on planning a reduction in force."

Peter Cappelli (University of Pennsylvania), "Public policy and downsizing decisions."

NOTE: These papers are available in the Chicago Fed's *Economic Perspectives*, Second Quarter, 2005, "Job loss: Causes, consequences, and policy responses," Vol. 29, No. 2.

The rate of job displacement may also have implications for macroeconomic and monetary policy. From the perspective of monetary policy, the implications of displacement are complicated, because an increase in job displacement may have two offsetting effects. First, the current unemployment rate may overstate the amount of slack in labor resource utilization if a higher proportion of the unemployed are likely to take a long time to find a new job. Second, if a higher fraction of the unemployed lack the skills necessary for current vacancies, shortages may arise that would put upward pressure on labor costs. However, if job displacement is relatively common, workers may be reluctant to press for wage increases, restraining labor costs.

This *Chicago Fed Letter* summarizes some of the presentations at a two-day job loss conference held at the Chicago Fed. The first day of the job loss conference focused on new research findings. The second day featured an address by Michael Moskow, president of the Federal Reserve Bank of Chicago,<sup>1</sup> and panel discussions on layoffs. A special issue of the Chicago Fed's *Economic Perspectives* presented papers by our keynote speakers, Lisa Lynch of Tufts University and Henry Farber of Princeton University, and the second-day panel participants.<sup>2</sup> Titles and authors of these papers are listed in figure 1. Here, we highlight some of the research findings from the first day's presentations, which focus on 1) the impact of job loss on workers; 2) the intersection of regulation and job loss; and 3) the effects of job loss on firms; we also briefly summarize some of the conclusions from both days' discussions.

### **The impact of job loss on workers**

It is important to understand what types of individuals are likely to suffer most or least in the event that they are displaced. This is valuable from the perspective of targeting policies after a layoff, but it may also be important for workers as they consider what types of skills to invest in early in their careers.

Research by Peter Kuhn (University of California, Santa Barbara) and Arthur

Sweetman (Queen's University) explores whether workers with "multiple skills" suffer, on average, smaller earnings losses than other workers after a displacement occurs. Kuhn and Sweetman find that workers in jobs that require multiple skills earn more than other workers. Furthermore, workers who are displaced from these jobs have higher earnings in subsequent jobs. However, part of these higher earnings appears to be the result of the workers' training. After the researchers control for the time it takes to train for the job, multi-skilled individuals have lower earnings than individuals who do not describe themselves as multi-skilled, in both the pre- and the post-displacement jobs. However, earnings *loss* associated with job loss is smaller for the multi-skilled.

Kuhn and Sweetman point out that their results cannot be interpreted as "causal," since it is possible that workers who are more adaptable simply sort themselves into jobs requiring multiple skills.

Clearly, the effects of job loss may be different for workers with different characteristics. In particular, as the work force ages, it is critical for policymakers to understand how the effects of displacement differ for older and younger workers. Research presented by Todd Elder (University of Illinois) documents that job displacement does affect older workers differently. He finds that there has been an increase in involuntary job loss due to the elimination of positions for workers over age 50 in the past two decades. He also finds that workers over 50 have longer spells of unemployment and greater earnings losses than their younger counterparts. However, younger workers may suffer larger earnings losses over their working lives, because they will receive the lower post-displacement wage over a longer period.

Elder's findings are consistent with the idea that the need for health insurance makes older workers willing to accept a full-time job with benefits, even if the earnings are low. Thus, changes in health insurance policies are likely to affect the labor supply of workers over the age of 50.

Finally, it is important to understand the best policies for helping displaced workers to find new jobs. One possibility is to retrain workers. However, little is known about the value of providing training to displaced workers. Many previous studies of the value of government-subsidized (post-high-school) training were conducted for young workers with few skills. Displaced workers tend to be older, since they have substantial work experience, with many, albeit perhaps outdated, skills. Research on retraining at community colleges by Louis Jacobson (CNA), Robert LaLonde (University of Chicago), and Daniel Sullivan (FRB Chicago) finds that, first, older displaced workers use community colleges less than younger displaced workers. Second, the increase in per-period earnings for each credit earned is similar for older and younger workers. Third, because younger workers have more of their working lives remaining, training them appears to be a better investment—though even for older workers, the benefits of training outweigh the costs. Finally, the returns to some courses are much higher than to others. Technical courses such as nursing are more likely to be good investments than nontechnical courses such as history.

These presentations prompted a number of questions. For example, should workers be encouraged to acquire multiple skills and at what age? Should it only be after formal schooling? What, if anything, should government do for older workers? What are the implications for pensions and health insurance? Should we retrain more workers? Should we have a system of vouchers or reemployment bonus accounts?<sup>3</sup>

### **Regulation and job loss**

A paper by Stephen Woodbury (Michigan State University) examines the impact of experience-rating unemployment insurance (UI) on the temporary layoff behavior of firms.<sup>4</sup> Currently, the UI system is tailored to address short bouts of unemployment, not permanent job loss. However, we need a better understanding of how the UI system affects temporary layoffs for a number of reasons. First, temporary layoffs are costly

for workers. In addition, if there were fewer temporary layoffs, we might be able to structure the UI system better to meet the needs of displaced workers, for whom job loss is most costly in terms of earnings loss.

Woodbury uses unique panel data from the states of Missouri, Washington, and Pennsylvania, with several special features. First, the unit of observation is not the employee but the employer. Second, Woodbury uses UI administrative data, allowing explicit observation of the tax rates and incentives to lay off for each employer. Finally, he has a long panel to control for unobserved employer effects. In the end, he finds that increased experience rating significantly reduces layoffs.

International trade and outsourcing receive a disproportionate share of the attention surrounding job displacement. The paper presented by Lori Kletzer (University of California, Santa Cruz), coauthored with Howard Rosen (Trade Adjustment Assistance Coalition), provides an overview of the assistance the government provides to workers who have lost their jobs through trade.

Kletzer and Rosen find that the labor market in the United States is very flexible and that most of the “burden of this flexibility is borne by U.S. workers, their families, and communities.” They also suggest that there is increased anxiety over trade liberalization and potential growth of services outsourcing. They say that the current system of assistance to unemployed workers is “no longer adequate.” Kletzer and Rosen point out that trade adjustment assistance is the area in which policymakers have been more willing to reform and expand assistance to displaced workers.

This session also raised some interesting policy issues. Clearly, when it comes to displaced workers, labor market policy and trade policy are closely linked. Many asked whether it makes sense to make a distinction between the case where one loses a job because someone overseas does something “better” than her company versus the case where someone in another state in the U.S. does. There is

more public assistance available to workers who are displaced from manufacturing jobs due to trade than from other industries, even though the causes and the consequences may be similar.

However, it can be difficult to identify which workers are “displaced” versus those who simply lost their jobs for other reasons. For example, the presentation by Maia Guell (Universitat Pompeu Fabra) and Jose E. Galdon-Sanchez (Universidad Publica de Navarra) on firing costs suggested that firms are sometimes reluctant to reveal their true reasons for dismissing workers to avoid paying the costs associated with layoffs. On the other hand, workers may have an incentive to claim that they are in the “displaced” group, if that group receives more generous treatment.

### The impact of layoffs on firms

In the final session of the day, Henry S. Farber (Princeton) and Kevin F. Hallock (Cornell) concentrated on the very short-term (three-day) reaction of stock prices to job loss announcements. Hallock presented research documenting the short-term relationship between job loss announcements and stock prices using a very large sample of all job loss announcements in all firms ever in the Fortune 500 in any year between 1970 and 1999. While the effect of job loss on workers is clearly negative, some have suggested that business owners profit handsomely from large layoffs as stock prices increase in the wake of such announcements. If large layoffs are viewed by the market as evidence that management is aggressive about cutting costs and increasing profits, then the chief executive officer and others may benefit from decisions that hurt workers. On the other hand, the market may view layoffs as an indication that the executives have information about bad times ahead and the stock price may fall. Farber and Hallock find that the number of job loss announcements follows the business cycle quite closely. Second, the overall stock price reaction to job loss announcements was most negative early in the sample period and has become less negative over time. Third, “clean” announcements (that

is, separate from other announcements that might also affect stock prices) have larger negative effects than others. The authors find no evidence that, *on average*, firm owners are profiting from large increases in stock prices by laying off workers. However, the stock price reactions vary, so some business owners gain and some lose stock value after their layoff decisions.

### Conclusion

The general discussion at the job loss conference highlighted the diversity of points of view in the audience. Many economists agree that changes like technological progress and increased competition, while imposing costs on some, bring benefits for the majority, and that those benefits are greater than the costs. However, even if one accepts that these changes generate benefits that are so large that those who benefit *can* compensate those who bear the costs, it does not automatically follow that such compensation actually happens.

Participants agreed that in the United States a great deal rests on having a job. In addition to salary, access to health insurance is generally through one’s employer. Thus, job loss may have effects beyond labor market outcomes.

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The current UI system may not be optimally designed to meet the needs of displaced workers. In addition, however, they may need incentives to return to the labor market, because the wages they face on the subsequent job are typically substantially lower than on the job they lost.

Trade adjustment assistance goes further toward addressing the particular needs of those facing a permanent job loss. However, it makes little sense to make these programs available only to workers displaced from manufacturing jobs due to import competition. Workers who lose service sector jobs due to changes in technology will face similar reemployment challenges.

Training appears to yield benefits greater than the costs for displaced workers who voluntarily seek retraining through community colleges. In particular, technical

and vocational classes, such as nursing, have a high return. There may be an important role for programs that advise displaced workers about which types of training may be most worthwhile.

Currently, several states are piloting “re-employment bonus account” programs. These programs would give unemployed workers a sum of money that they could use to obtain training. If they get a job within some specified period, they would get to keep any remaining money as a bonus. This pilot program may be a creative way to encourage retraining. However, as with all such programs, rigorous evaluation is needed to ensure that scarce public resources are used effectively.

Peter Cappelli (University of Pennsylvania) pointed out a seeming conundrum of the U.S. labor market: At the same time that many firms are contemplating a reduction in force, the same

firms are complaining about the difficulty of retaining qualified workers. The unfettered flexibility that firms have to lay off unneeded workers may have an unintended consequence—if the risk of layoff permeates the firm–employee relationship, then the relationship will be inherently unstable. This may lead to increased costs for the firm, for example, in training of new employees. Under some circumstances, firms, workers, and the economy might be better off if firms gave up some of their flexibility to lay off workers.

The United States enjoys a higher standard of living due, in part, to our willingness to embrace change. However, there will be winners and losers associated with these changes. Many participants agreed that it is critical to have policies that help compensate those who lose in this equation, since this will help ensure that we continue to have a dynamic economy.

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<sup>1</sup> The text of this speech is available at [www.chicagofed.org/news\\_and\\_conferences/speeches/2004\\_11\\_19\\_job\\_loss.cfm](http://www.chicagofed.org/news_and_conferences/speeches/2004_11_19_job_loss.cfm).

<sup>2</sup> The articles in the *Economic Perspectives*, Second Quarter, 2005, are available at [www.chicagofed.org/economic\\_research\\_and\\_data/index.cfm](http://www.chicagofed.org/economic_research_and_data/index.cfm), under the link labeled “Economic Perspectives.”

<sup>3</sup> Reemployment bonus accounts were proposed in the first term of the Bush Administration. These would consist of a sum of money that long-term unemployed workers could use for training. If the worker found a job within a specified period, he or she could keep any unused funds, which would constitute a “bonus” for reemployment.

<sup>4</sup> Firms pay a tax into the unemployment insurance system. That tax rate is based on their past layoff experience; thus, it is “experience rated.” However, there is a cap such that once the top tax rate is reached, further layoffs do not increase the tax a firm pays; thus, the unemployment insurance tax is said to be “incompletely” experience rated.