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When Data Mislead: the uncounted employed

This recovery from the recession of 2001 has puzzled analysts and markets for many reasons. One puzzle is where are the jobs? The hallmark of this recovery is the very poor performance of measured employment. Even compared to the recession of 1990-1991, employment performance has been awful although reminiscent. At the same time, productivity has soared. That should have warned all of the analysts, including this one, that we had left something out of our analysis. Our data measure output reasonably well. If a computer is made, we record it, albeit accounting properly for quality change still causes macro accounting problems. But, what about our maids and our gardeners and the "technerds" that fix our home LAN or are office servers who want to be paid in cash? Well, our spending increased, but that "output" was produced by zero labor input, at least, for national accounting purposes. Maybe that's the missing link in this recovery? Maybe that's the reason that productivity is soaring, but jobs are not? If so, some of the conventional wisdom about the looming problem of no job growth is going to be very, very wrong.

The conventional wisdom is that the current "juice" to the economy stemming from easy monetary policy and exceptionally expansive fiscal policy will begin to run out sometime in 2004. The salvation is job growth that sustains personal income. But what if the jobs aren't there? That depends upon one's definition of employment. If it comes from the data collected in the Establishment Surveys of the Department of Labor, it's going to miss your gardener and your housekeeper and your technerd. Yet, output will keep going up and more importantly, since you paid each of these underground employees, they will spending their "green," even if the taxman doesn't cometh!

Over the years, as levels of taxation rise to support the growing demands of legislative entitlements, some workers revolt. They want real disposable income, not highly visible, taxable income. And, consumers want services, even if they are supplied by an underground economy. Here, there is a trade. Both participants benefit from the trade by leaving the taxman out. More importantly, from a macro standpoint, the data being generated in such an accounting framework can mislead. The larger the underground economy, the bigger the disparity between measured output and measured input. Ergo, productivity grows, jobs don't but consumption expands, stimulated by the growth of real disposable income, even when the income is unrecorded.

Today's NY Times published a marvelous article on this subject that all investors ought to read. Daniel Akst goes right to the heart of the underground economy. And, read correctly, the article may point investors in an unconventional direction. If the fraction of the economy that is underground keeps growing, and we do nothing about estimating it in the way we collect data, then productivity is going to rise, simply as an artifact of the enumeration problem. The macro implications are interesting. Since consumer income will continue to rise, even when a portion of that income is not "counted," corporate profits are going to rise, driven by this expanding consumption. It will seem over time that measured 'savings' are falling because our measured 'income' number is going to understate how much spending power is available to consumers. Those of us who purport to tell investors what to expect should be warned. We are going to consistently underestimate the power of the consumer.

Some investors were convinced early this spring that the consumer was going to "fail," and corporate profits were going to fall short of analyst expectations. That was a losing hand on the investment front. Maybe part of the reason that the consumer didn't fail is that we failed to properly count his "income," and jobs that generated that income? What's to stop us from undercounting in 2004?

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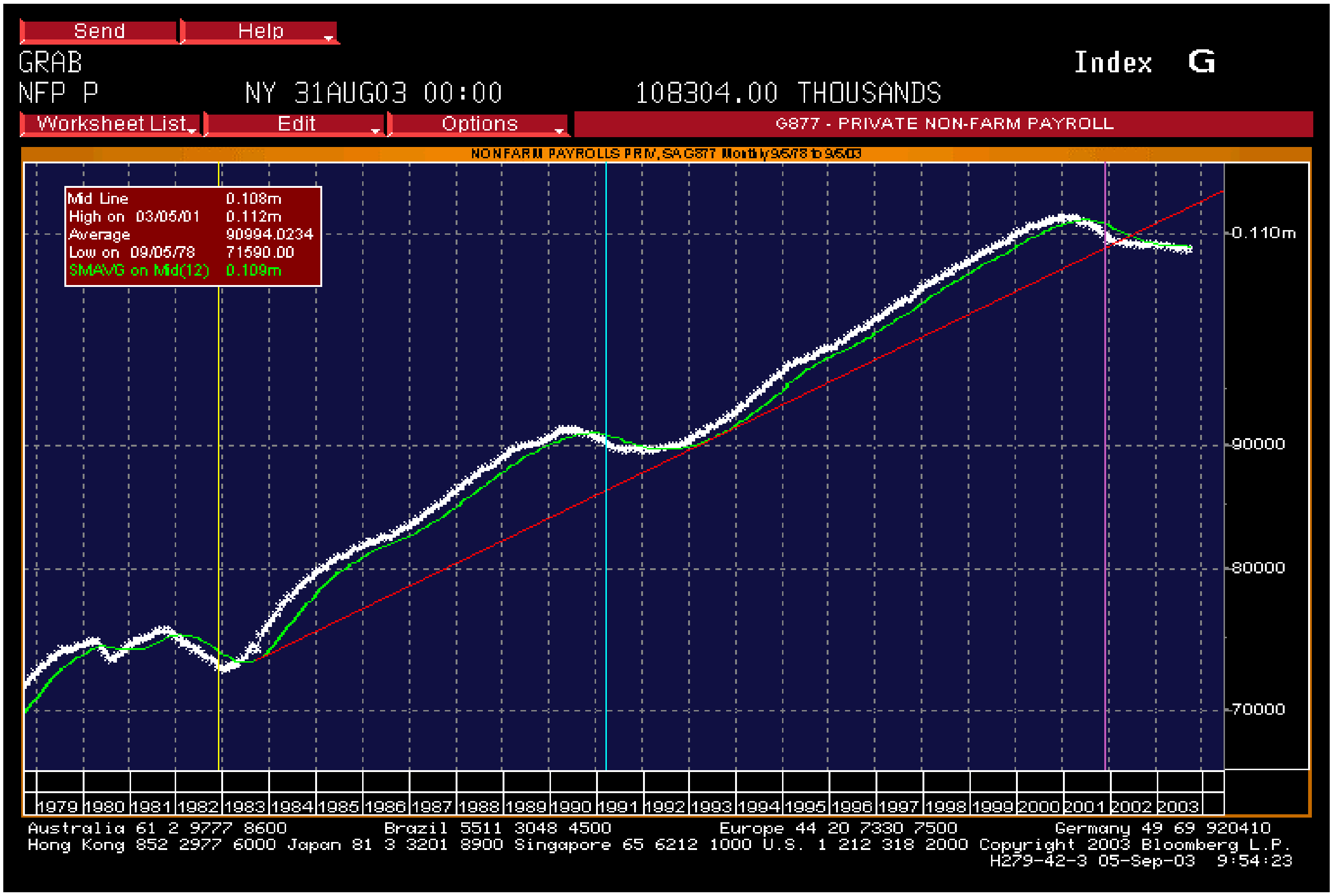

From the New York Times, Sunday September 7, 2003

ON THE CONTRARY Look Underground, and Unemployment Is Low

By DANIEL AKST

Another Labor Day has passed, with the usual cookouts, marches and store sales but characteristically little notice of what may be the fastest-growing part of the work force: those who labor off the books. By its nature, of course, the underground economy is hard to measure. But it's not hard to see. Lately, it has been all around us, which is especially noteworthy now that the unemployment rate seems stuck at more than 6 percent.

Some people have suggested that the unemployment figure is deceptively low. There are, after all, more than two million people in prison, many more than in decades past, and disability claims are up, too. If all these potential workers were counted, the unemployment rate would indeed be higher. But the number of such potential workers is far exceeded by the total of those working off the books — whose labors would drive down the unemployment rate significantly if counted. That is especially true by historical standards, because the amount of underground economic activity has been expanding so much.

The International Monetary Fund, in a global survey of underground economic activity last year, found that this sector has been growing in the United States for 30 years. The authors of the I.M.F. report have estimated underground economic activity at 8.6 percent of gross domestic product in the United States, up from 6.7 percent in 1990 and just 4 percent in 1970. Because most people who work off the books are in labor-intensive fields — investment bankers and heart surgeons tend to operate within the confines of the tax system — it is a safe bet that 9 percent of G.D.P. translates to more than 9 percent of the work force.

No one is sure how many people work off the books. But most of us don't need the I.M.F. to tell us that the total is significant. If you have children, for instance, you may be paying somebody off the books to care for them, perhaps full time. Edgar L. Feige, a retired economist at the University of Wisconsin who is an authority on the underground economy, has estimated from currency data that unreported income in the United States more than doubled during the 1990's, reaching $1.25 trillion in 2000.

One reason for this growth is the arrival of millions of immigrants, especially illegal ones. There were an estimated 8.7 million illegal immigrants in this country in 2000, according to the Census Bureau. And a large proportion is working off the books for employers who appreciate cheap, compliant labor free of employment regulations and payroll taxes. Another reason is the growing importance of the service economy: it is easier to keep this activity off the books. In the case of childcare, for instance, parents do not want to wrestle with paperwork and payroll taxes, while the childcare providers often prefer to avoid taxes. In effect, parents get cheaper labor while workers get higher wages.

Changes in society over the decades have also encouraged off-the-books work. Women's participation in the labor force exceeded 60 percent in 2001, up from 34 percent in 1950. That change has created much more demand for childcare, gardening and other domestic help.

While a large underground economy suggests a lot of tax evasion, it also implies something positive: that inflation is even lower than the official rate. And, of course, it means that an awful lot of employment is not captured by government statistics.

So I'm doubtful that unemployment was a big problem this Labor Day, especially given the odds that someone out of work might be living with someone else who still has a job and thus can put food on the table. That the United States economy has produced enough jobs for millions of women and immigrants over the years — without unemployment soaring far beyond 6 percent — is close to miraculous.

The real problem is what has happened to the least skilled — and least paid — workers. From 1979 to 2001, according to the Bureau of Labor Statistics, the real earnings of men without high school diplomas fell by a horrifying 28 percent. For women, whose pay was already lower, the decline was still 9 percent. Here, too,

Immigration and off-the-books labor have played roles, by sharply increasing the pool of low-skill labor.

A lot has changed since Labor Days past. But we still haven't managed to repeal the law of supply and demand.

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