

By the end of this chapter, you should be able to:

- explain what is meant by unemployment
- explain the difficulties involved in measuring unemployment
- discuss the costs of unemployment
- distinguish between the different causes of unemployment
- evaluate the measures that may be taken to reduce unemployment.

As we know, a low level of unemployment is one of the main macroeconomic goals of every government. Unemployment is a highly publicized topic; a low and/or falling unemployment rate is widely interpreted as a sign of improved health of an economy. The following article introduces a few of the key issues surrounding the topic of unemployment. It is useful to have a quick look at these before developing the theory.

Canadian unemployment rate edges up to 6.4%

Canada's jobless rate increased slightly to 6.4% in April as job growth slowed, Statistics Canada said Friday. The rate rose a tenth of a percentage point from March, but still remained near 30-year lows.

Statistics Canada said 22 000 new jobs—all full time—were added to the nation's payrolls last month, significantly more than the 15 000 that economists had expected.

That brings the number of jobs created since the start of the year to 124 000. Employment in the first four months is growing by twice the rate of the same period last year.

Ontario led the country in job creation for the second straight

month as the province added 23 800 jobs, mostly among adult women. Ontario has added 108 000 new jobs over the past 12 months as growth in service sector positions has outweighed losses in manufacturing.

Employment in Quebec fell by about 24 000 in April for the province's first significant decline this year. It was the only province to record a new job loss last month.

Job creation in Alberta and British Columbia was relatively flat last month after outpacing the rest of the country for the past 12 months. Those two provinces still have the lowest jobless rates in the country.

For once, manufacturing jobs actually rose. Stats Can said

24 500 factory jobs were added in April. That still leaves the country's manufacturers with 165 000 fewer jobs than in 2002 when the Canadian dollar began its relentless rise towards the current level of 90 cents US.

Statistics Canada said that strong full-time employment growth over the last year and an unemployment rate perched around its record low continue to push wages up. The average hourly wage in April was up 3.1% from April 2005.

Source: *CBC News*, May 5, 2006

Some of the points raised in the article are as follows.

- Unemployment essentially means just what it says—"jobless".
- A change in the unemployment rate of even a tenth of a percentage point is considered to be "news".

- The unemployment rate is affected by how many jobs are created in the economy.
- The number of jobs created will vary in different industries (e.g. manufacturing or services) and may be different for different groups of people (e.g. men or women).
- While a country will publicize a national unemployment rate (Canada = 6.4%), the rates in different regions will differ from this national average.
- Many things will affect the unemployment rate, e.g. exchange rates, costs of raw materials, and international economic conditions.
- The unemployment rate will have an effect on wage rates.

What is unemployment and how is it measured?

According to the International Labour Organization (ILO), unemployment is defined as “people of working age who are without work, available for work, and actively seeking employment” (www.ilo.org).

By definition, the unemployment rate is the number of people who are unemployed expressed as a percentage of the total labour force (not the whole population). The labour force, otherwise known as the work force, is essentially the “economically active population”.

Although it varies from country to country, there is a specified age at which people are eligible to start work and to retire. Anybody outside this age is not part of the work force. Students attending school are not part of the work force, as they are not looking for work. Similarly, parents who stay at home to look after children are not considered to be part of the labour force. People who are not considered to be part of the labour force would include children, students, stay-at-home parents, retired people, and others who are choosing not to (or are not able to) work. Even though they do not have jobs, such groups are not considered to be unemployed. Because they are not actively seeking employment, they are not part of the labour force.

It may be surprising to realize that it is actually quite difficult to measure the size of the labour force and the number of people that are unemployed. Each country has its own national system for measuring the number of people that are unemployed. Information is gathered from national censuses and surveys of the population, along with administrative records such as unemployment insurance records and social security information. It is worth noting that there may be inaccuracies in such data and there may also be inconsistency in the definitions across different countries.

The following gives an example of possible differences in measurement. Unemployment data may be based on the people who are registered as unemployed, as in Austria or Switzerland. Alternatively, it may be calculated as the number of people who are claiming unemployment benefits, as in Britain and Belgium. However, even within these two approaches, there may be problems measuring the true number of people unemployed. For example, the incentive to register as unemployed is likely to depend on the availability of unemployment benefits. A person who is not entitled to any benefits is not likely to register as unemployed.



Hidden unemployment

One problem that exists in the calculation of unemployment is the existence of *hidden* unemployment. Hidden unemployment consists of several different groups of people. The first group includes those people who have been unemployed for a long period of time and have given up the search for work. Since they are no longer looking for work, presumably having lost hope, they are no longer considered to be unemployed. Another group of people who make up the hidden unemployed are people who have part-time work but would really like to be working full time. Since they are working part time they are obviously not considered as unemployed. They might not be earning as much as they would like, or need, and would like to find a full-time job, but have to stay in the part-time job as it provides better income than having no job. Yet another group of people hidden from official unemployment figures are people who are working in jobs for which they are greatly over-qualified. Again, such people would like to find work that utilizes their skills and pays higher income, but must stay in the lower-skilled job as it is better than no job at all.



Student workpoint 17.1

Be an inquirer

You have already gathered the data for the unemployment rate in your chosen OECD country. Now find out exactly how the government defines and calculates the unemployment rate.

DID YOU KNOW?

What does the International Labour Organization do?

The International Labour Organization is the UN specialized agency which seeks promotion of social justice and internationally recognized human and labour rights. It was founded in 1920 and is the only surviving major creation of the Treaty of Versailles which brought the League of Nations into being; it became the first specialized agency of the UN in 1946.

The ILO formulates international labour standards in the form of Conventions and Recommendations setting minimum standards of basic labour rights: freedom of association, the right to organize, collective bargaining, abolition of forced labour, equality of opportunity and treatment, and other standards regulating conditions across the entire spectrum of work-related issues. It provides technical assistance primarily in the fields of:

- vocational training and vocational rehabilitation
- employment policy

- labour administration
- labour law and industrial relations
- working conditions
- management development
- cooperatives
- social security
- labour statistics and occupational safety and health.

It promotes the development of independent employers' and workers' organizations and provides training and advisory services to those organizations. Within the UN system, the ILO has a unique tripartite structure, with workers and employers participating as equal partners with governments in the work of its governing organs.

Source: www.ilo.org

Student workpoint 17.2**Be knowledgeable**

- 1 Read through the description of the mandate of the ILO in the Did you know? box.
- 2 Have a look at the homepage of the ILO (www.ilo.org) to develop an awareness of the type of work carried out by this international organisation. At the time of writing, some of the discussions include:
 - The “Go for the Goal ... End Child Labour” campaign coinciding with the football World Cup in South Africa
 - The establishment of a New International Labour Standard on HIV and AIDS to fight against the stigma and discrimination against workers living with HIV or believed to be HIV positive
 - the work involved in ensuring that the benefits of globalization can reach more people
 - a partnership with the All China Federation of Trade Unions to promote gender equality and decent work in China through “strengthening workers’ education and social dialogue”
 - the issue that “although Cambodia is emerging as one of the brightest economic growth stories of Southeast Asia, over 313 000 children are trapped in the worst forms of exploitation such as drug trafficking and prostitution”.

Make your own list of four contemporary issues being addressed at the ILO.

Source: www.ilo.org

Distribution of unemployment

Along with differences in methods of measurement, and the existence of hidden unemployment, it is worth pointing out another limitation of the unemployment rate. As with many other indicators, a national unemployment rate establishes an average for a whole country, and this is very likely to mask inequalities among different groups within an economy. One should be careful in using the national rate as a basis for making conclusions about different groups of people. These are some of the typical disparities that exist among different groups of people within a country:

- *Geographical disparities:* Unemployment is likely to vary quite markedly among regions in a country, as most countries do have some regions that are more prosperous than others. Inner city unemployment might be quite a bit higher than suburban or rural unemployment.
- *Age disparities:* Unemployment rates in the under-25 age group are higher than the national averages in many countries.
- *Ethnic differences:* Ethnic minorities often suffer from higher unemployment rates than the national average. This may be the result of differences in educational opportunities or possibly due to attitudes and/or prejudices of employers.
- *Gender disparities:* Unemployment rates among women have tended to be much higher than rates for men in many industrialized countries. There may be all kinds of reasons for this: differences in education, discrimination by employers, or other social factors.

Costs of unemployment

The reason that governments place such importance on reducing the level of unemployment is because unemployment poses great costs on an economy. It should be pointed out that the costs of unemployment increase the longer that people are unemployed. The costs listed below are really those costs associated with long-term unemployment. These costs can be grouped into different categories.

- *Costs of unemployment to the unemployed people themselves:* People who are unemployed face several costs. First of all, unemployed people will receive less income than they would do if they were employed. This is assuming that they receive some unemployment benefits. Clearly if there are no unemployment benefits, then the situation is much worse. A reduction in income implies a lower standard of living for those that are unemployed and perhaps their families as well. The costs worsen the longer the people are unemployed. It is quite likely that a person who remains unemployed for a long period of time could become increasingly dejected and this could contribute to high levels of stress and the problems associated with stress such as anxiety and depression. Erosion of mental health can lead to relationship break-downs and, in the extreme, higher levels of suicide.
- *Costs of unemployment to society:* The social costs of unemployment can most clearly be seen in areas where there are high levels of unemployment in the form of poverty, homelessness, higher rates of crime and vandalism, increased gang activities, and so on. While it would be a simplification to blame these problems entirely on unemployment, they are not unconnected.
- *Costs of unemployment to the economy as a whole:* A production possibilities curve can be used to illustrate the key problem facing an economy with unemployment—if actual output is less than potential output due to the unemployment of the factor of production, labour, then the economy is foregoing possible output and would be operating at a point within its production possibility curve. This loss of output, and income to the unemployed, has other implications for the economy as a whole. For instance, there is the opportunity cost of the government's spending on unemployment benefits. If unemployed people who have lower incomes pay less direct tax and spend less money, the government earns less in indirect taxes as well. The government may have to spend more money to solve the social problems created by unemployment.

What are the main factors affecting the level of unemployment?

At any given point in time there will be a number of people that are unemployed. This may be referred to as the “pool” of unemployment. But this “pool” will be in a constant state of change. At any given time people are becoming unemployed while others are gaining employment. The level of unemployment depends on the relationship between these two. If more people are becoming unemployed than gaining jobs, then the level of unemployment will rise. If more jobs are being created so that more people are gaining jobs than losing

Student workpoint 17.3

Be an inquirer

Investigate the distribution of unemployment in your chosen OECD country by looking at the unemployment rates for:

- different regions
- different age groups
- different ethnic groups
- men and women.

Present the information in the form of tables or graphs. Other than the national statistics office or the OECD, the ILO might be a useful resource.

“You take my life when you do take the means whereby I live.”

William Shakespeare,
The Merchant of Venice

Student workpoint 17.4

Be a thinker—illustrate the following.

Using a production possibilities curve, explain the costs of unemployment to an economy.

Student workpoint 17.5

Be an inquirer

Try to assess some of the problems associated with unemployment in your chosen country.

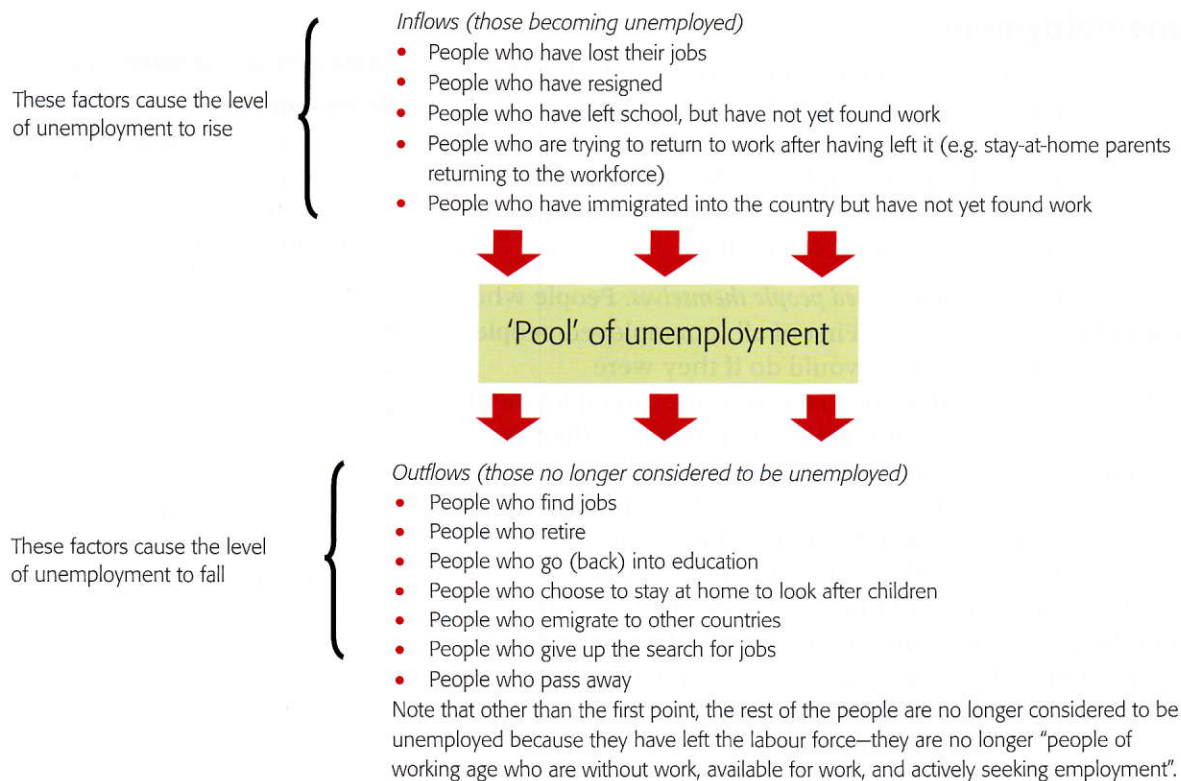


Figure 17.1 Inflows and outflows from the “pool” of unemployment

jobs, then the level of unemployment will fall. These can be referred to as the inflows and outflows into the “pool” of unemployment and are illustrated in Figure 17.1.

The movements in and out of the pool of unemployment affect the supply of labour in an economy at any given time. This, along with the demand for labour, will determine the level of employment and unemployment in an economy.

Causes of unemployment

There are two main categories of unemployment. Although these terms are not specifically mentioned on the IB Diploma Programme syllabus, they help to understand the causes of unemployment. The categories are: equilibrium unemployment and disequilibrium unemployment. Before looking at each type, it is necessary to introduce the concepts and diagrams explaining an economy’s labour market.

The labour market

The labour market is illustrated in Figure 17.2.

The diagram shows the macroeconomic labour market. The y-axis on the diagram represents the price of labour, as measured by the average real wage rate. This shows the average level of wages adjusted for inflation. The labour market represents the demand and supply for *all* labour in the economy. Thus the demand for labour is more accurately called the aggregate demand for labour (AD_L) as it includes the demand not just for one type of worker but for all the labour that is involved in producing an economy’s goods

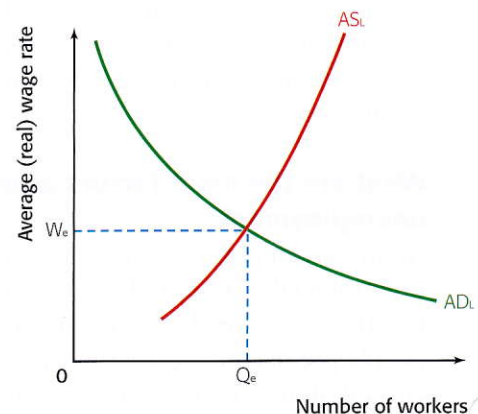


Figure 17.2 Equilibrium in the labour market

and services. For example, it includes the demand for teachers, assembly line workers, sales people, pizza deliverers, motorcycle mechanics, and bankers, to name a few. The aggregate demand curve shows the total demand for labour at every given average wage rate. The aggregate demand curve slopes downwards, because at a lower real wage level, producers are more willing to take on more labour—i.e. producers' demand for workers increases. As the wage level increases, firms attempt to reduce the amount of labour that they use, perhaps by using more capital-intensive production methods.

The aggregate demand for labour curve is dependent on aggregate demand in the economy. If AD increases, and more output is produced, it may be assumed that more labour is demanded to produce the extra output. Similarly, if AD falls it is assumed that firms will need fewer workers to produce the lower level of goods and services demanded.

The aggregate supply of labour curve (AS_L) illustrates the total number of an economy's workers that are willing and able to work in the economy at every given average wage rate. As the average wage rate increases, more people are willing to work and so the ASL curve slopes upwards.

The labour market is in equilibrium where the aggregate demand for labour is equal to the aggregate supply of labour. Although it resembles any microeconomic demand and supply diagram, it is actually a macroeconomic model, as it describes aggregates in the economy. The equilibrium wage for the economy is established by this interaction of ADL and ASL and is shown on the diagram as W_e .

Disequilibrium unemployment

Disequilibrium unemployment occurs when there are any conditions that prevent the labour market from "clearing", that is, reaching the labour market equilibrium. There are two types of disequilibrium unemployment.

Real-wage unemployment (or classical unemployment)

The first type of disequilibrium unemployment, real-wage unemployment (or classical unemployment), is illustrated in Figure 17.3.

This type of unemployment may be referred to as classical unemployment as it represents the view of classical (and new classical) economists that argue that some unemployment is caused by trade unions and government minimum wages interfering with the labour market. Trade unions negotiate wages that are higher than the equilibrium and a minimum wage is set above the equilibrium. As a result of the higher enforced wage (W_1), the aggregate supply of labour is greater than the aggregate demand for labour, and unemployment of a-b is created. (You should be able to see that this "surplus" of labour represents the same outcome as discussed in Chapter 5 on minimum prices.) In this situation, the trade unions and/or the government are preventing the market from clearing.

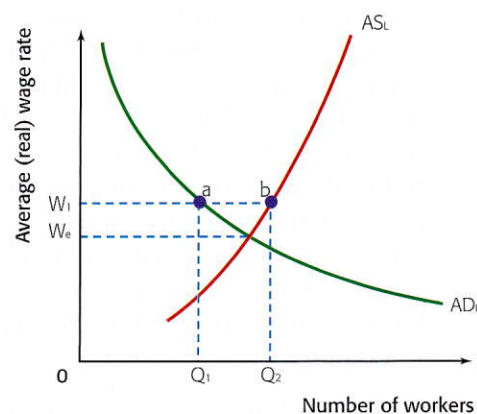


Figure 17.3 Real-wage unemployment

Solutions to real-wage unemployment

The solutions to this type of unemployment are clear. If the trade unions are preventing the labour market from clearing, then the government should reduce the ability of unions to negotiate higher wages. Similarly, if the minimum wage prevents the market from clearing, then the minimum wage should be reduced, or even abolished.



There are obvious consequences to such policies. First of all, it might be quite difficult to reduce union power. Second, and perhaps more importantly, the effects of such policies will harm poorest workers the most. High-income workers are not the ones who receive minimum wages; a reduction in the minimum wage will reduce the income and living standards of those workers who are already earning low wages. Thus such a policy can lead to a worsening distribution of income within an economy—greater inequity.

You are not required to be familiar with this type of unemployment (real wage unemployment) for the exam, but it does broaden your understanding of unemployment. The concepts of minimum wages and trade union power are very important in understanding labour market and equity issues.

Demand-deficient unemployment or cyclical unemployment

This type of disequilibrium unemployment is associated with the cyclical downturns in the economy. As an economy moves into a period of slower growth (or negative growth in the case of a recession), aggregate demand tends to fall as consumers spend less on goods and services (see Figure 17.4(a)). This is likely to lead to a fall in the demand for labour, as firms cut back on production. This is illustrated in Figure 17.4(b).

Assume that the economy is initially operating at a high level of economic activity at Y_1 in Figure 17.4(a). There is aggregate demand for labour at AD_L in 17.4(b) so the equilibrium wage will be W_e for Q_e workers. The labour market is in equilibrium.

If the economy slows down, aggregate demand is likely to fall as shown in Figure 17.4(a). To reduce their output, firms will reduce their demand for labour from AD_L to AD_{L1} as shown in Figure 17.4(b). If labour markets functioned perfectly, then the average real wage would fall to W_1 . However, this is not the case, and we say that wages are “sticky downwards”. This means that while workers’ wages can easily increase, it is less likely that real wages will fall. There are several reasons for this wage “stickiness”. First of all, firms realize that paying lower real wages is likely to lead to discontent and reduced motivation among workers. This may result in lower worker productivity and is undesirable. Secondly, firms may not be able to reduce wages due to labour contracts and trade union power. Since wages are likely to remain “stuck” up at W_e , the aggregate supply of labour will be greater than the aggregate demand for labour and unemployment of $a-b$ will be created.

This type of unemployment has a third name—Keynesian unemployment. As discussed in Chapter 16, Keynes observed that it was quite possible for the economy to operate well below full

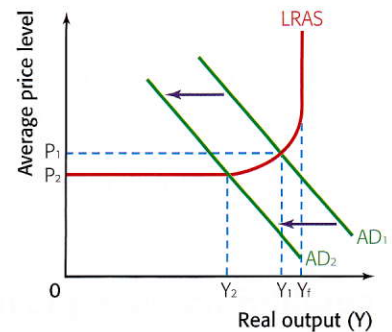


Figure 17.4 (a) A decrease in AD

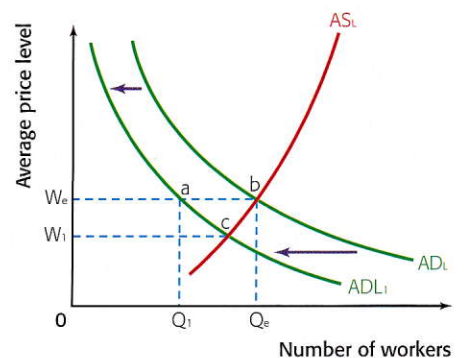


Figure 17.4 (b) Demand-deficient unemployment

employment, and this was likely to result in high levels of unemployment.

Solution to demand deficient unemployment

Given that the problem is due to the low level of aggregate demand, the solution to this type of unemployment should also be clear—the government can intervene to bring about an increase in aggregate demand through the use of fiscal or monetary policies. That is, the government can use Keynesian demand management policies.

Since the problem is caused by insufficient aggregate demand in the economy, the government could use fiscal policy by increasing AD itself through increased government spending, or it could lower direct and indirect taxes to indirectly increase consumption by households and investment by firms. The central bank could use monetary policy by decreasing interest rates or increasing the money supply.

Equilibrium unemployment (natural unemployment)

Theoretically, the labour market may be in equilibrium, with no demand deficient or real-wage unemployment, but there might still be unemployed people. This is because there are other types of unemployment that occur even when the labour market is in equilibrium. When the labour market is in equilibrium, the number of job vacancies in the economy is the same as the number of people looking for work. This is full employment where there is no disequilibrium unemployment. Jobs exist, but people are either unwilling or unable to take the jobs that are available. This is best understood through the use of Figure 17.5.

This diagram introduces a new curve—a measure of the total labour force (LF). Why is the number of workers in the labour force greater than the aggregate supply of labour? Recall that the aggregate supply of labour shows the number of people *willing and able to work at every given wage rate*. But at any given wage rate, there will be more people looking for jobs than those who are actually willing and/or able to take the jobs. Thus, at W_e , Q_e people are willing and able to take jobs, yet $a-b$ unemployment exists.

Although it is difficult to observe on the diagram, the fact that there is no disequilibrium in the labour market means that there *are* jobs available but $a-b$ people are either not willing or not able to take the jobs. For example, perhaps there are job vacancies in the financial services industry, but the unemployed assembly line workers are not able to take the jobs because they lack the appropriate education and skills. Or perhaps there are job vacancies in the domestic services industry, but the unemployed mechanical engineers are unwilling to take them. Or perhaps there are jobs available for computer programmers, but the unemployed computer programmers are not aware that these jobs are available. In each of these three examples, the unemployed workers are either unable (the assembly line workers and the computer programmers) or unwilling (the mechanical engineers) to take the jobs that are available.

Notice that the gap between the aggregate supply of labour curve and the labour force curve becomes smaller at higher wages. This is

Student workpoint 17.6

Be a thinker

Using a diagram, explain how fiscal policy might be used to decrease demand deficient unemployment.

Assessment advice: Treat this as an exam question where you would define relevant terms, draw appropriate diagrams, explain the diagram to apply the theory, and include examples where a government might have used such a policy.

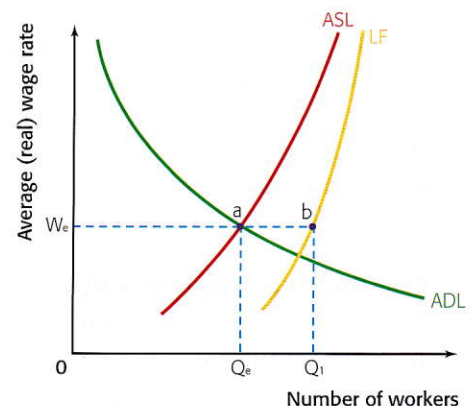


Figure 17.5 Equilibrium unemployment

common sense. At low wage rates, there are fewer workers that are *willing* to work; people would rather be unemployed than take the jobs that are available. But as the real wage rate rises, more people are willing to take the jobs, thus the gap between the two decreases.

There are three main types of equilibrium unemployment—frictional, seasonal, and structural unemployment. Together they make up what is known as the natural unemployment in the economy. An economy is at full employment when the unemployment that exists in the economy is only the natural employment.

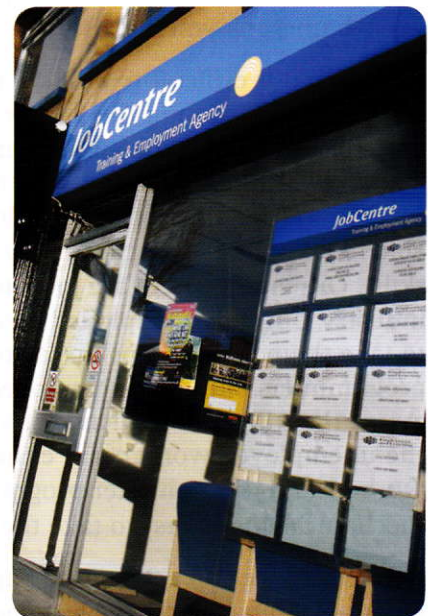
In the next section, the three types of natural unemployment are explained. In simplified terms, there is one common feature—jobs exist but the people are either unwilling or unable to take these jobs. Thus the solutions for each type of unemployment share the characteristic that they are designed to make people more *able* to take the vacant jobs, or encourage them to be more *willing* to take the available jobs. As a result, in each case the aggregate supply of labour will shift to the right. Solutions to these types of unemployment are types of supply-side policies, as they are designed to increase the quantity and improve the quality of labour. These are generally the same as explained in Chapter 15, but these policies are focused specifically on the labour market. Remember that we tend to group supply-side policies into two categories—interventionist and market-based policies. True to their name, the interventionist policies rely on government involvement in the labour market, while the market-based policies emphasize the importance of allowing the labour market to function freely without government intervention.

Frictional unemployment

This is the short-term unemployment that occurs when people are in between jobs, or they have left education and are waiting to take up their first job. This type of unemployment is easily recognizable as *natural* unemployment as it is natural for people to leave jobs in the hopes of finding better ones. Moreover, it is not generally perceived to be a negative outcome in any dynamic economy. If people leave one job, the assumption is that they will move on to a job where they can be more productive. As soon as such members of the labour force get a job, they will be able to contribute more to the economy.

Solutions to frictional unemployment

Even though frictional unemployment is not seen as a serious problem in an economy due to its short-term nature, there are ways that governments can reduce this level of unemployment if it is believed that people are remaining unemployed for too long a time. Some would argue that people will have little incentive to find a job if the unemployment benefits available to them in their country are generous and allow them to take their time in looking. Thus, economists who prefer to allow markets to operate freely would say that governments should lower unemployment benefits to encourage unemployed workers to take the jobs that are available rather than allow them the chance to wait for a better one to come along. If unemployment benefits were reduced, then the



unemployed workers might become more willing to work, thus shifting the aggregate supply of labour to the right.

Sometimes people who are frictionally unemployed remain without work because they are not aware of appropriate vacancies that exist. In such a case, frictional unemployment can be reduced by improving the flow of information from potential employers to people looking for jobs. This can be through such things as internet job sites, newspapers, job centres, and employment counsellors. This would reflect a more interventionist approach.

Seasonal unemployment

It is natural in many economies for some workers to be employed on a seasonal basis. That is, the demand for certain workers falls at certain times of the year. For example, in temperate climates where there is a cold winter there may be unemployed construction workers or farmers. The tourism industry tends to work in seasons—for example, there is not much call for a ski instructor in Austria in July.

Solutions to seasonal unemployment

Such unemployment can be reduced by encouraging people to take different jobs in their “off season”. The methods mentioned above, reduced unemployment benefits and greater flow of information, are appropriate here as well.

Structural unemployment

This is by far the worst type of equilibrium unemployment and occurs as a result of the changing structure of an economy. Structural unemployment occurs when there is a *permanent* fall in demand for a particular type of labour. This is natural in a growing economy, as while there will always be new types of jobs being created (e.g. software engineers), other jobs in a country may disappear (e.g. coal mining), making people unemployed. One reason that it is so harmful is that it tends to result in long-term unemployment as people who lose their jobs in one area lack the necessary skills to take on the newly-created jobs. We say that they lack the occupational mobility to change jobs. It may be that jobs are created in one part of the country, while the unemployed are living in another part of the country. Here, we say that they lack the geographic mobility.

There are different causes of structural unemployment.

- It is possible that new technologies can make certain types of labour unnecessary. By its very nature, automation reduces the need for labour. For example, automated teller machines (ATMs) have reduced the demand for human bank tellers. This can be referred to as technological unemployment.
- Demand for a particular type of labour might fall due to lower-cost labour in foreign countries. For example, there is less demand for furniture makers in Italy as a result of competition with Chinese furniture makers whose costs are lower. This is resulting in higher unemployment among Italian furniture makers.

- Changes in consumer taste may lead to a fall in demand for a particular type of labour. For example, people in some areas are increasingly concerned about the negative externalities associated with the production and consumption of coal. This has led to a search for alternatives and a fall in the demand for coal in some countries. As a result, coal miners have become structurally unemployed.

A slightly different way of looking at structural unemployment would be to consider ways that changes in the institutional framework of an economy affect the labour force. The institutions that could be included here include laws governing the labour market, trade unions, or even cultural traditions such as the role of women in the workforce. For example, consider the case where there is a law which states that firms may not fire workers unless they give lengthy documentation and proof of inefficiency or malpractice. Most people would agree that this is a very important right that should be given to all workers. However, this law might also prevent some firms from hiring workers, as they fear the costs of dismissing them should the workers not be efficient. A change in the law reducing the protection of workers (deregulation) would give firms more incentive to increase their demand for labour. Using another example, a key responsibility of trade unions is to protect their union members. It may be that firms are prevented from hiring certain workers, who might be willing and able to work, because the union does not allow the firms to employ non-union members. In this case the union would be contributing to the unemployment in the economy and a reduction in the trade union power would reduce unemployment.

We can use a diagram to illustrate structural unemployment. Consider the case of manufacturing workers in Canada, as illustrated in Figure 17.6. Given that the cost of employing labour in manufacturing in emerging/developing economies is lower than in high income countries there has been a fall in demand (D_1 to D_2) for manufacturing labour in higher-wage countries such as Canada. The consequence of this is that there are fewer manufacturing workers employed (Q_1 to Q_2) and the wage falls from \$16 per hour to \$12 per hour. From this diagram we can assume that unless these workers can find other jobs there is an increase in unemployment of the amount $Q_1 - Q_2$.

Please note an important distinction between demand deficient unemployment and structural unemployment. Demand deficient unemployment is caused by an overall (and temporary) fall in the demand for **all** labour in the economy as a result of a slowdown in economic growth or a recession. The expectation would be that once aggregate demand picks up then the aggregate demand for labour should also increase. Structural unemployment is caused by a permanent fall in the demand for **one** type of labour and requires a different set of solutions.

However, it should be noted that demand deficient unemployment caused by a lengthy period of economic activity could result in structural unemployment. This could occur because, as the economy

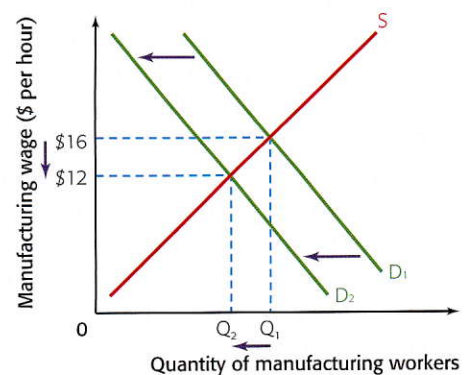


Figure 17.6 A fall in employment (structural unemployment)



picks up, it is quite possible that new forms of labour are needed, while workers who were made redundant during a recession do not have the skills needed for the changing economic climate.

Solutions to structural unemployment: interventionist policies

A key here is to try to enhance the occupational mobility of people, so that they become more able to take available jobs.

- A long-term solution involves an education system that trains people to be more occupationally flexible. Evidence suggests that people in more developed economies will have to change jobs several times in their career. Thus it is clear that an education system must make people able to learn the skills to adapt to rapidly changing economic conditions.
- Another strategy to improve occupational mobility involves spending on adult retraining programmes to help people acquire the necessary skills to match available jobs.
- Another possibility is for the government to give subsidies to firms that provide training for their workers.
- If jobs exist in other parts of a country, a government might provide subsidies or tax breaks to encourage people to move to those areas. This enhances their geographic mobility.
- Governments can also support apprenticeship programmes, such as those available in Germany and Austria, so that potential workers can acquire the skills needed in the labour force.

There are two main disadvantages to such policies. The first is that they are likely to involve a high opportunity cost as governments will have to forego spending in other areas in order to be able to afford the strategies. The second is that these policies are really only effective in the longer term.

Solutions to structural unemployment: market-based/free market supply-side policies

- One strategy is similar to the suggestion to reduce frictional unemployment. Governments should reduce unemployment benefits to give unemployed people the incentive to take the jobs that are available.
- Market-oriented economists feel that government intervention and labour market regulations reduce “labour market flexibility” and discourage businesses from hiring workers. They would argue that regulations about hiring and firing, for example, make businesses less willing to take on new workers, so they would argue in favour of deregulation of labour markets. This would involve reducing or removing the legislation that businesses must follow in their hiring, firing, and employment practices.

The burden of such policies falls on two groups of people. First, people who lose their unemployment benefits will have lower living standards, and so such a policy can be said to increase inequity in an economy. Second, it can be assumed that labour market regulations are in place to protect workers from unfair

treatment, such as being fired without due cause. Labour market regulations also guarantee certain conditions of work such as working time, holidays, and safety at work. If there is labour market deregulation, it would not be surprising to find worse working conditions for labour. So although unemployment might fall, and the economy's output might rise, there might be a high cost for the workers themselves. Again, this can contribute to inequity in the economy where the benefits of higher economic growth are not shared by all.

Are demand-side policies or supply-side policies more effective in reducing unemployment?

It should be clear that the solutions to unemployment depend very much on the type of unemployment. If an economy is experiencing a downturn in economic activity, then it is likely that demand-deficient unemployment will rise, making demand management policies suitable.

There are of course concerns associated with such policies. In order to use expansionary fiscal policy, a government may have to run a budget deficit and spend more than it takes in revenues. While not necessarily a problem, particularly in the short run, this may lead to fiscal problems in the longer run. If governments reduce taxes, there is no guarantee that people will spend their extra disposable income; if consumer confidence is low then people might prefer to save and aggregate demand might remain depressed. If governments reduce interest rates to encourage spending there is no guarantee that it will have the desired effect of increasing consumption and/or investment. Once again, if consumer or business confidence is low then there is unlikely to be an increase in borrowing to finance consumption and investment.

Student workpoint 17.7

Be an inquirer

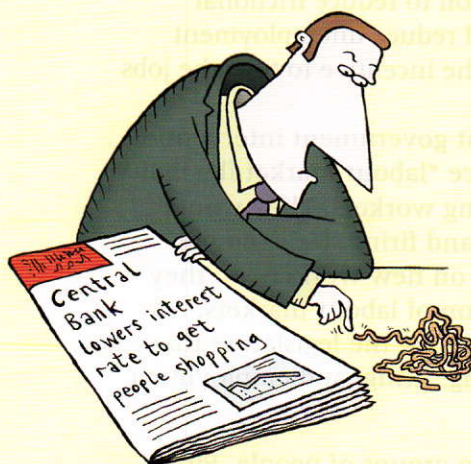
Research the labour market policies of the government in your chosen country. Consider the following questions:

- 1 How extensive are the labour market regulations (e.g. minimum wage, hiring and firing rules (job security), safety standards, length of work day, paid holidays)?
- 2 What does the government do to reduce the level of unemployment? Try to identify the policies that are interventionist and the policies that are market-oriented.

DID YOU KNOW?

J.M. Keynes is attributed with the expression "you can't push on a string" in relation to the effectiveness of using expansionary monetary policy to raise aggregate demand.

Give this experiment a try! Put a piece of string on a table and try to push one end to move it away from you. Does it work? To move the string you would have to pull the other end. Using this as a metaphor for lowering interest rates to raise AD, it is unlikely that monetary policy will be effective on its own, particularly if there is low household and business confidence.



Even when successful, there is likely to be a lag before they come into effect. It is possible that aggregate demand will increase, but by the time that it does, the economy may have already recovered, and the extra impetus can then be inflationary.

Another problem that occurs is due to the fact that even when the economy is at full employment, there will be some unemployment. We now know that this type of unemployment is natural unemployment and the solutions to these types are best found in supply-side policies. Using demand management policies to cure this type of unemployment will be unsuccessful. At full employment, the economy is producing near full capacity. Increases in aggregate demand at this point would result in inflationary pressure. We will address this further in the next chapter.

Fiscal policy – discretionary policy versus automatic stabilizers

We distinguish between discretionary fiscal policy and automatic stabilizers when discussing fiscal policy. Discretionary fiscal policy is a deliberate change to a government policy in order to manage aggregate demand, such as a decision to increase spending on infrastructure to expand the economy or to reduce spending on health care as a means of deflating the economy.

Automatic stabilizers, on the other hand, do not require any deliberate change to government policy in order to change the level of aggregate demand. These affect both government revenue and government expenditure. If there is high unemployment then government tax revenues will fall, as fewer people will be earning an income. It will not take any deliberate action on the part of the government to increase AD by lowering taxes. As far as the other tool of fiscal policy, government expenditure, is concerned, there will also be an increase in government spending. If there is high unemployment then there will be an increase in transfer payments to the unemployed (depending on the ability or willingness of the government to pay unemployment benefits). The government does not have to deliberately increase its own spending to increase AD, as this will happen automatically through the increased spending on unemployment benefits.

Automatic stabilizers are seen as important measures of controlling fluctuating economic activity because, since they automatically operate to increase aggregate demand when there is a slowdown in economic activity, they are not influenced by political decision making and not subject to the same time lags as discretionary policy would be.

The problem facing policy makers is that in practice it might be very difficult to distinguish between the different types of unemployment. Moreover, an economy may be suffering from several different types of unemployment. At any rate, it would be most common to see governments using a mix of demand- and supply-side policies. Demand-side policies, particularly the manipulation of interest rates, are commonly used to narrow possible business cycle fluctuations and reduce output gaps. Supply-side policies are vital to ensure that labour is suitably skilled and flexible to adapt to changing economic conditions so that the LRAS is always shifting to the right.

Crowding out

When governments run budget deficits in order to stimulate an economy and reduce unemployment, there is a potential problem known as “crowding out”. To run a budget deficit, the government has to borrow money. Governments do this by selling government bonds such as treasury bills or treasury bonds to financial institutions who then sell them on to people who want to save their money. What they are essentially doing is increasing demand for the savings, or loanable funds, that are in the economy. We illustrate the consequences of this increase in demand in Figure 17.7.

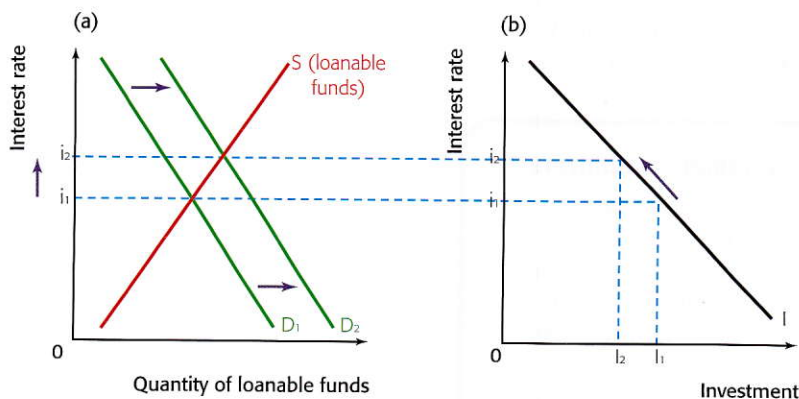


Figure 17.7 Crowding out

There is a given amount of savings in the economy and this is represented by the supply of loanable funds curve. The price of these loanable funds is the interest rate. The increased demand from D_1 to D_2 in Figure 17.7(a) for savings in order to finance a deficit results in an increase in the interest rate from i_1 to i_2 . The higher interest rate may reduce the incentive for businesses to invest, so it is possible that investment will fall from I_1 to I_2 , as shown in Figure 17.7(b). So we have a situation where the government wished to increase aggregate demand by increasing government spending, but the higher interest rate causes interest-sensitive private investment to fall, thus reducing aggregate demand.

Whether or not crowding out does occur and the extent to which it might occur is a subject of much debate in economics. To simplify the argument, Keynesian economists say that it will not occur if the economy is producing at less than full employment. The new classical economists, who are opposed to the use of demand management policies, argue that crowding out is a significant problem of increased government spending.

Data response exercise

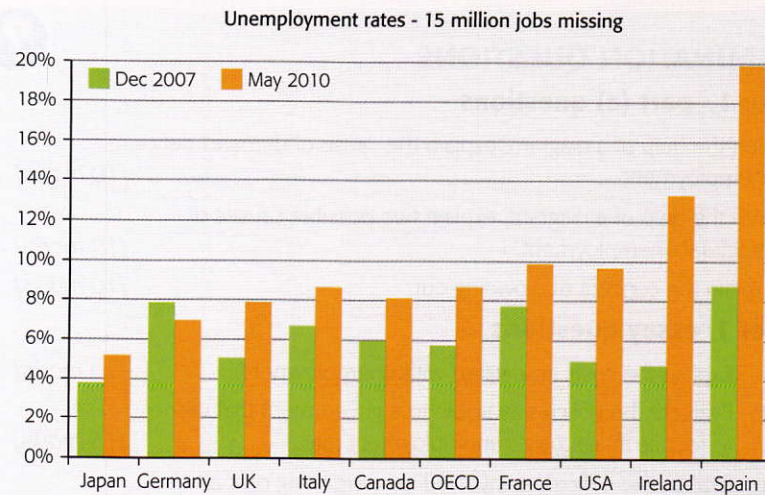
Read the following extract and answer the questions that follow.

Jobs gap – Wanted: 15 million posts

Economies in many developed countries may be starting to recover slowly from the recession but the jobs crisis looks set to last a while yet. By the end of 2011 OECD countries will need to create 15 million new jobs just to get employment levels back to where they were before the crisis hit.

Over the past two years (to the first quarter of 2010), unemployment increased by half in OECD countries to 8.7%. The rise in some countries, such as Iceland, Ireland, and Spain, was even greater. Unfortunately, that's only half the story. Include people who have stopped looking for work and part-timers who would like to work full-time and the true numbers for unemployment and under-employment throughout the OECD area are nearly twice as high as headlines suggest.

Recovery should help ease the problem, although it may take some time as employment growth usually lags behind other signs of recovery such as rising spending and trade. This time unemployment could prove to



be more intractable than usual, with real fears that some countries could be facing a jobless recovery. The prospect of long-term structural unemployment setting in seems real indeed.

Little wonder governments are under pressure to spend money to support existing jobs and to help create new ones. At the same time they are also under pressure to rein in public

spending, which grew substantially during the crisis. A strong case can be made for supporting jobs programmes, but governments must make sure they get maximum impact from that spending, while removing some of the barriers to jobs growth in their labour markets too.

Source: OECD Factblog, July 17, 2010

Use the Factblog from the OECD to answer the following questions:

- Using numbers from the chart, explain which country experienced the largest increase in unemployment from December 2007 to May 2010, and which country experienced the lowest increase.
- How might the official data under-estimate the true extent of unemployment?
- Using AD/AS analysis, explain how a recovery might help to reduce unemployment.
- What do you think is meant by the expression "jobless recovery"? Explain why this might be a danger.
- Using the text and your knowledge of economics, discuss the dilemma faced by governments.

Student workpoint 17.8**Be a thinker**

You have come across many types of unemployment in this chapter. Create a table that will show all of the different types of unemployment, their causes, and a brief note about appropriate solutions.

EXAMINATION QUESTIONS**Paper 1, part (a) questions**

- 1 With the help of a diagram, explain the cause of demand-deficient unemployment. [10 marks]
- 2 With the help of a diagram, explain two possible causes of structural unemployment. [10 marks]
- 3 Explain the concept of crowding out. [10 marks]

Paper 1, essay questions

- 1 **a** Explain the costs associated with unemployment. [10 marks]
- b** Evaluate the policies available to a government that wishes to reduce its country's unemployment rate. [15 marks]
- 2 **a** Explain the difficulties involved in interpreting official unemployment rate data. [10 marks]
- b** Evaluate the view that the only effective way to reduce unemployment is through government intervention. [15 marks]

Assessment advice: using diagrams and real-world examples

Sadly, students do not always read the instructions at the beginning of examinations. Therefore you are warned that the following words appear on the front cover of *all* of your economics exams: "Use fully labelled diagrams and real-world examples wherever possible." Here is the opportunity for you to make use of the information that you gathered about your chosen country. Put the information into your answer to support the economic theory.

All that work should pay off!

You be the journalist

Headline: Recession moves into its fourth quarter and takes its toll on the unemployed

Economics concept: Demand-deficient unemployment

Diagram: Disequilibrium unemployment

Hints: Explain why unemployment is likely to rise and consider the negative effects this might create. You could bring in ideas about what actions the government might be considering.