

# CIE Economics A-level

## Topic 4: The Macroeconomy

### d) Employment and unemployment

Notes



## Size and components of labour force

The working age population is between the ages of 18 and 65 who are actively looking for work. These are the economically active members of the population.

**Inactivity:** The economically inactive are those who are not actively looking for jobs. These could include carers for the elderly, disabled or children, or those who have retired. Some workers are discouraged from the labour market, since they have been out of work for so long that they have stopped looking for work. If the number of the economically inactive increases, the size of the labour force may decrease, which means the productive potential of the economy could fall.

The **unemployed** are those able and willing to work, but are not employed. They are actively seeking work and usually looking to start within the next two weeks. Those in **employment** are those with a job.

## Labour productivity

This is a measure of output per worker per hour. It is equivalent to how much real GDP is produced per unit of labour per hour.

## Full employment and natural rate of unemployment

The unemployment rate when the labour market is at equilibrium is called the natural rate of unemployment. It is a concept developed by Milton Friedman and Edmund Phelps.

This type of unemployment is the difference between those who are willing to have a job at the current market wage level, and those who are willing and able to have a job. It is caused by supply-side factors.

It includes the frictional level of unemployment, structural unemployment and workers who do not have the necessary skills for a job.

It is also called the NAIRU: non-accelerating inflation rate of unemployment. It means that inflation does not have a tendency to increase at this unemployment rate. Sometimes, it is also referred to as the full level of employment, since there is no demand-deficient unemployment.



In the long run, the unemployment rate reverts to the natural rate of unemployment. However, it can fluctuate around this rate due to economic variables.

Full employment is the state when all factors of production are used to their productive potential. It maximises the output of the economy.

This could put up upward pressure on the price level, since consumer demand in the economy is high which will lead to demand-pull inflation. There could also be wage inflation, which can push up the price of production for firms. This is since labour is in shortage.

There are social benefits of having full employment. Crime rates might fall if more people are in employment, and standards of living might increase if people have more disposable income. Inequality and poverty might fall if fewer people are unemployed.

Consumers and firms might have more confidence in an economy where resources are used to their full potential. This should encourage long term sustainable growth. With full employment, government budgets might improve since tax revenues increase and spending on welfare benefits falls.

Governments aim to have as near to full employment as possible. They account for frictional unemployment by aiming for an unemployment rate of around 3%. The labour force should also be employed in productive work.

### **Consequences of unemployment**

If consumers are unemployed, they have less disposable income and their standard of living may fall as a result.

There are also psychological consequences of losing a job, which could affect the mental health of workers.

With a higher rate of unemployment, firms have a larger supply of labour to employ from. This causes wages to fall, which would help firms reduce their costs.

However, with higher rates of unemployment, since consumers have less disposable income, consumer spending falls so firms may lose profits. Producers which sell inferior goods might see a rise in sales.

It might cost firms to retrain workers, especially if they have been out of work for a long time.

Unemployment leads to a waste of workers' resources. They could also lose their existing skills if they are not fully utilised.



If the unemployment rate increases, the government may have to spend more on JSA, which incurs an opportunity cost because the money could have been invested elsewhere.

The government would also receive less revenue from income tax, and from indirect taxes on expenditure, since the unemployed have less disposable income to spend.

Unemployment leads to an opportunity cost to society, since workers could have produced goods and services if they were employed.

There could be negative externalities in the form of crime and vandalism, if the unemployment rate increases.

## Types of unemployment

### Structural unemployment

This occurs with a long term decline in demand for the goods and services in an industry, which costs jobs. This is especially true of jobs in industries such as car manufacturing, where labour is replaced by capital (this is also called **technological unemployment**). Moreover, the decline of the coal and ship building industries in the UK, led to a great deal of structural unemployment.

This type of unemployment is worsened by the geographical and occupational immobility of labour. If workers do not have the transferable skills to move to another industry, or if it is not easy to move somewhere jobs are available, then those facing structural unemployment are likely to remain unemployed in the long run.

Globalisation also contributes to structural unemployment, since production in the manufacturing sectors, such as in clothing or motor cars, moves abroad to countries with lower labour costs. This means that workers trained for these jobs will become unemployed, because the industry has declined in size or has been removed from the economy.

### Frictional unemployment

This is the time between leaving a job and looking for another job. It is common for there to always be some frictional unemployment, and it is not particularly damaging since it is only temporary.



For example, it could be the time between graduating from university and finding a job.

This is why it is rare to get 100% employment: there will always be people moving between jobs.

### Seasonal unemployment

This occurs during certain points in the year, usually around summer and winter. During the summer, more people will be employed in the tourist industry, when demand increases.

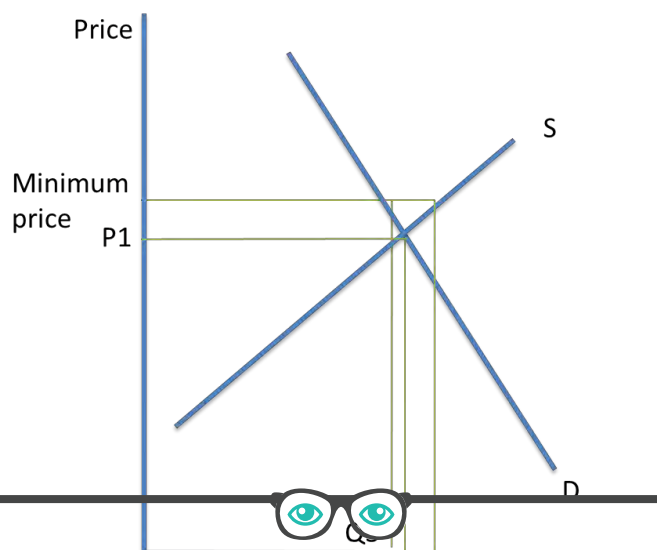
### Demand deficiency (cyclical unemployment)

This is caused by a lack of demand for goods and services, and it usually occurs during periods of economic decline or recessions. It is linked to a negative output gap. Firms are either forced to close or make workers redundant, because their profits are falling due to decreased consumer spending, and they need to reduce their costs. This then causes output to fall in several industries.

This type of unemployment could actually be caused by increases in productivity, which means each worker can produce a higher output, and therefore fewer workers are needed to produce the same quantity of goods and services.

### Real wage unemployment

Wages above the market equilibrium may cause unemployment. This is because the supply of labour exceeds demand. Classical economists argue that by letting wages fall to the equilibrium level, there would be no unemployment.



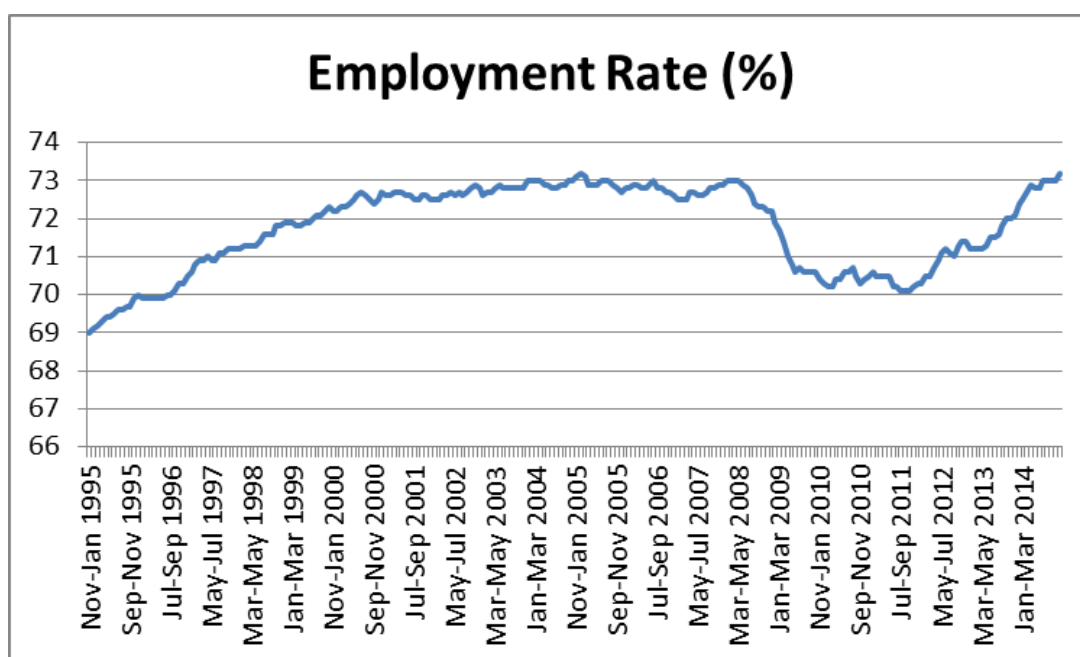
In the diagram, the point at 'minimum price' reflects the NMW. This causes unemployment of Q1 – Q3.

If demand then shifts to the left, due to a fall in consumer spending for example, there would be more unemployment since wages are not able to adjust.

Classical economists would argue that by letting wages be flexible, by removing trade union power and removing the NMW, wages could fall and unemployment would fall to 0.

However, cutting wages during times of weak consumer spending would cause further falls in consumer spending, and there would be even lower economic growth. Moreover, the classical economist argument is made on the assumption of a perfectly competitive market, which is not true in reality.

### Unemployment rate; patterns and trends in (un)employment



The graph shows the employment rate for people aged 16-64 between 1995 and 2014 in the UK. In December 2014, the employment rate peaked at 73.2%. As the graph shows, the employment rate fell during the period of the financial crisis. After the start of the crisis, the employment rate fell to 70.1%.

### Difficulties involves in measuring unemployment

It is usually difficult to accurately measure unemployment. Some of those in employment might claim unemployment related benefits, whilst some of the unemployed might not reveal this in a survey.

The two main measures of unemployment in the UK are:

#### The Claimant Count

This counts the number of people claiming unemployment related benefits, such as Job Seeker's Allowance (JSA). They have to prove they are actively looking for work.

#### Evaluating the Claimant Count:

Not every unemployed person is eligible for, or bothers claiming JSA. Those with partners on high incomes will not be eligible for the benefit, even if they are unemployed. Although there may be instances of people claiming the benefit whilst they are employed, the method generally underestimated the level of unemployment.

#### The International Labour Organisation (ILO) and the UK Labour Force Survey (LFS)





The LFS is taken on by the ILO. It directly asks people if they meet the following criteria:

- Been out of work for 4 weeks
- Able and willing to start working within 2 weeks
- Workers should be available for 1 hour per week. Part time unemployment is included.

Since the part time unemployed are less likely to claim unemployment benefit, this method gives a higher unemployment figure than the Claimant Count.



## Policies to correct unemployment

-  Supply-side policies are the only policies which can deal with structural unemployment, because the labour market can be directly improved with education and training.
-  Demand-side policies are better at dealing with cyclical unemployment, since they can reduce the size of a negative output gap and shift the AD curve to the right.
-  There are significant time lags associated with supply-side policies.
-  Market-based supply-side policies, such as reducing the rate of tax, could lead to a more unequal distribution of wealth.

