

# WJEC (Wales) Economics A-level

## **Macroeconomics**


### Topic 2: Macroeconomic Objectives

#### **2.2 Unemployment**

Notes



## **Unemployment, employment and the government macroeconomic objective**

 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.

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. When this employment rate is met, the economy is said to have full employment.

## **Measures of 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.

## **The causes 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.

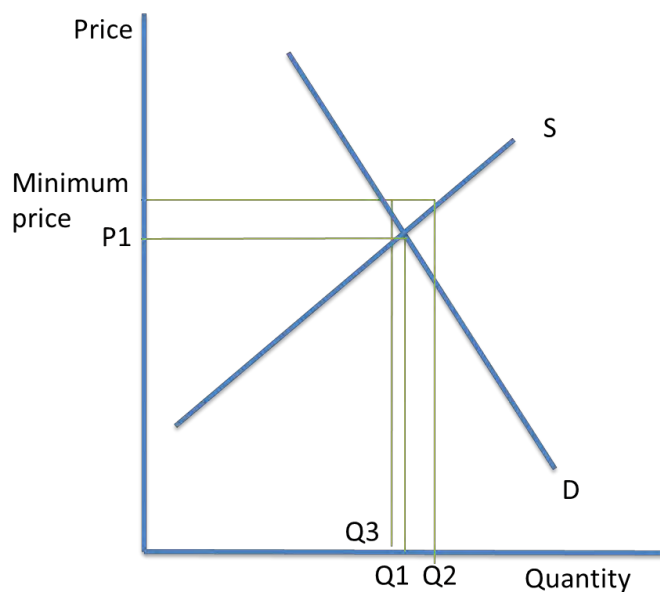
### **Demand deficiency (cyclical unemployment)**

This is caused by a lack of demand for goods and services, and it usually occurs during periods of economic decline or recessions. 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 inflexibility**

Wages above the market equilibrium may cause unemployment. 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.

Keynesians disagree with this because of inflexible labour markets. Keynes coined the phrase 'sticky wages'. Wages in an economy do not adjust to changes in demand. The minimum wage makes wages sticky and means that during a recession, rather than lowering wages of several workers, a few workers might be sacked instead.

### **The consequences of unemployment:**

#### ○ **Consumers**

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.

#### ○ **Firms**

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.



- **Workers**

With unemployment, there is a waste of workers' resources. They could also lose their existing skills if they are not fully utilised.

- **The government**

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.

- **Society**

There is 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.

### **The effects of full employment:**

-  This 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.

### **The natural rate of unemployment**

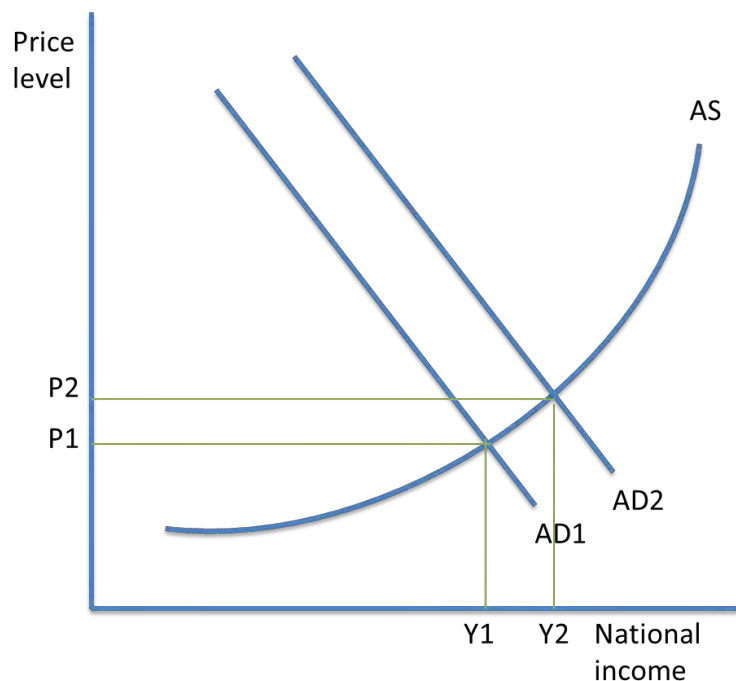


- 📄 The unemployment rate when the labour market is at equilibrium is called the natural rate of unemployment. It is a concept developed by Milton Friedman and Edmund Phelps.
- 📄 This type of unemployment is the difference between those who are willing to have a job at the current market wage level, 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.

### 📄 Solutions to unemployment

- 📄 The solution used to tackle unemployment will depend on the cause and nature of unemployment. However, governments generally use either demand-side or supply-side policies.
- 📄 Demand-side policies might be used to increase AD during a recession or a negative output gap. This might be achieved through either fiscal or monetary policy.
- 📄 Demand-side policies are policies designed to increase consumer demand, so that total production in the economy increases.
- 📄 This could be done during periods of economic decline. Negative output gaps can be reduced with the use of demand-side policies. Demand-side policies can increase AD from AD1 to AD2.
- 📄 Since AD increases, firms make higher profits, so they need to hire more workers to meet the increasing demand. Moreover, they can afford to hire more workers.



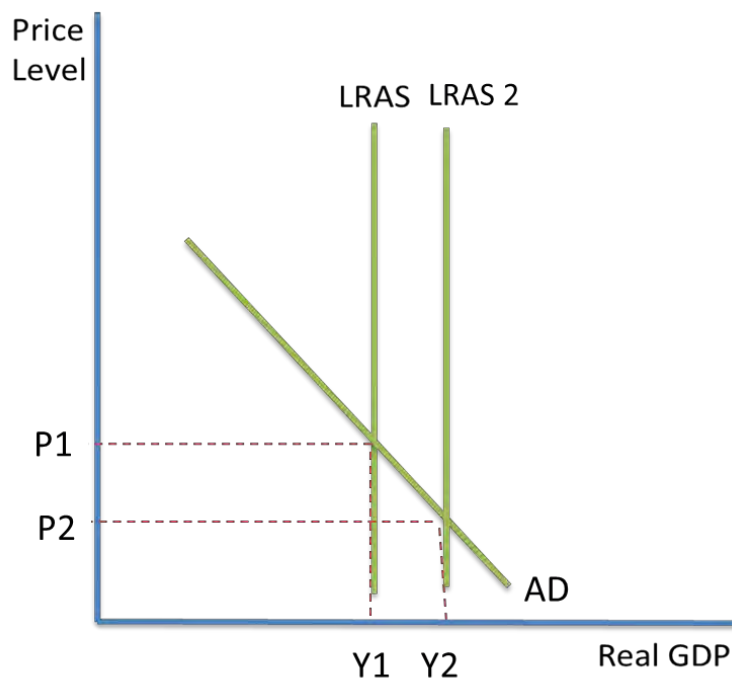


- **Limitations**
- Governments might have imperfect information about the economy. It could lead to inefficient spending.
- There is a significant time lag involved with employing fiscal policy. It could take months or years to have an effect.
- If the government borrows from the private sector, there are fewer funds available for the private sector, which could lead to crowding out.
- The bigger the size of the multiplier, the bigger the effect on AD and the more effective the policy.
- If interest rates are high, fiscal policy might not be effective for increasing demand.
- If the government spends too much, there could be difficulties paying back the debt, which could make it difficult to borrow in the future.





Supply-side policies can be used to increase the productive potential of the economy. This is depicted by a rightward shift in the LRAS curve.



### Education and training

The government could subsidise training or spend more on education. This also lowers costs for firms, since they will have to train fewer workers. It makes the quality of labour better, which results in a more productive workforce. This increases the potential output of an economy.

By improving access to training and education, it becomes more convenient for people to improve their skills, which is likely to encourage them to do so. For example, universities might use access schemes to encourage more people to apply, or apprenticeships might become more widely available.

### Reforming tax and benefits, or reducing marginal tax rates

By reducing income and corporation tax, governments could encourage spending and investment.



Tax reforms could encourage more people to work, and benefits could be more stringent. They can also encourage more entrepreneurship.

### **Improving labour market flexibility**

Reducing the National Minimum Wage (or abolishing it altogether) will allow free market forces to allocate wages and the labour market should clear.

Governments could try and improve the geographical mobility of labour by subsidising the relocation of workers and improving the availability of job vacancy information.

Working arrangements could be made more flexible.

### **Immigration**

Migration can fill skills gaps and reduce the unemployment rate. This could result in higher productivity among the labour force.

### **Trade union reform**

Reducing trade union power makes employing workers less restrictive and it increases the mobility of labour. This makes the labour market more efficient.

### **Infrastructure development- including consideration of transport market**

Governments could spend more on infrastructure, such as improving roads and schools. This could make transport more efficient, since it will take less time and cost less to move between places. It might also contribute to the geographical mobility of labour.

### **Research and development incentives**





This can encourage more investment, which can benefit the economy in the long run by helping firms find more efficient methods of production and innovating.

### **Subsidies**

These could be directed towards small businesses to encourage them to expand, or to lower training costs for firms.



### **Strengths and weaknesses of supply-side policies:**

-  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.

