

## UNEMPLOYMENT

Unemployment refers to a situation where a proportion of an economy's labourforce who are actively seeking jobs cannot find jobs.

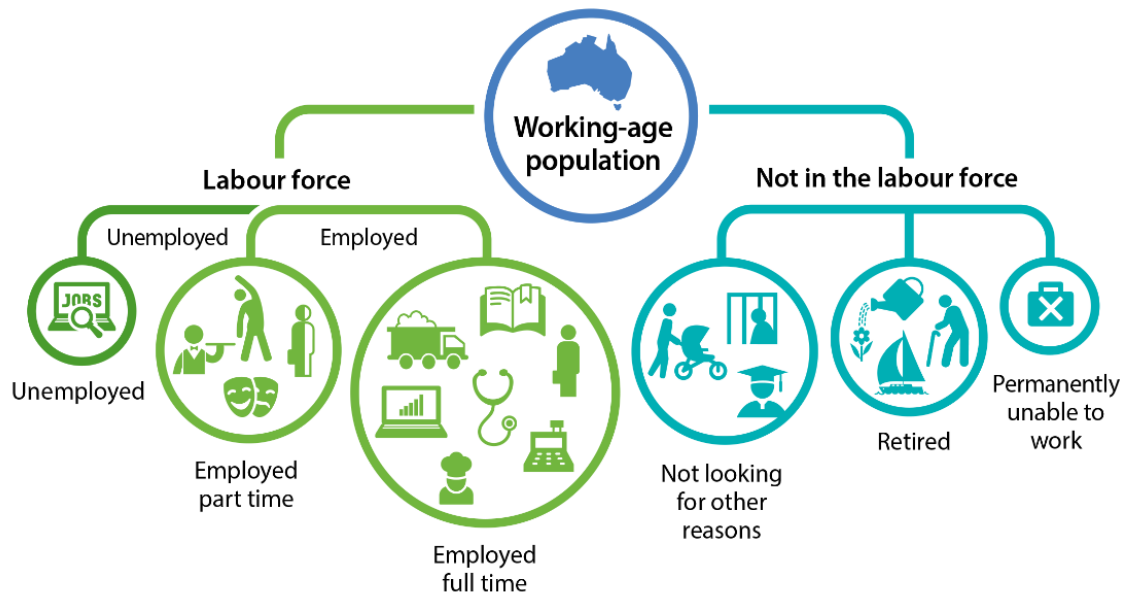
High unemployment or low employment is considered as a major macroeconomic problem because of two reasons.

1. First, unemployment affects the distribution of economic well-being among an economy's citizens. People who cannot find jobs suffer a loss of income. Even in the presence of unemployment benefits and other assistance from the government, the unemployed typically have lower living standards as compared to the employed.
2. Secondly, the impact of joblessness on the unemployed themselves affects the entire society. A high unemployment rate implies that the economy is not achieving its full economic potential: Many people who want to work and produce additional goods and services are not able to do so. With the same number of people, but fewer goods and services to distribute among that population, the average standard of living will be lower.

One measure economists use to keep track of employment is the unemployment rate. **The unemployment rate** is the measure of the proportion of the laborforce that is actively seeking jobs but cannot find one.



## Groups in the Labour Market



### Computations of unemployment in class exercise

$$\text{Labourforce} = \text{Unemployed} + \text{Employed}$$

$$\text{Unemployment rate} = \frac{\text{Unemployed}}{\text{Labourforce}} \times 100\%$$

**Employed=12.6 million**

**Unemployed= 0.7 million**

**Compute the unemployment rate. =5.26%**

$$\text{Participation rate} = \frac{\text{Labourforce}}{\text{Working age population}} \times 100\%$$

**Working age population=20 million. Estimate the participation rate.**

**=66.5%**

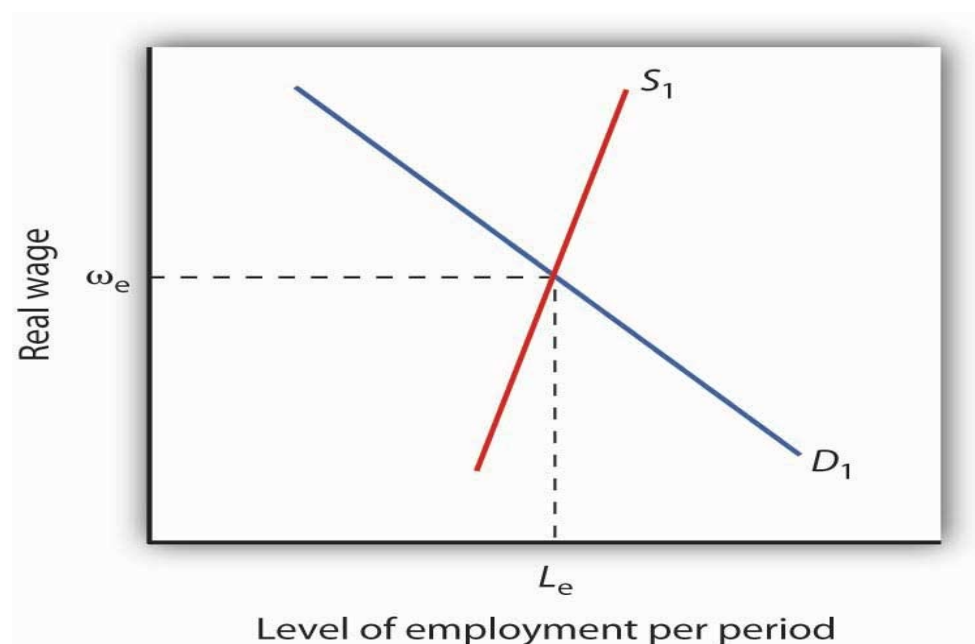
## Theory of Unemployment

**Natural level of employment** applies the demand and supply model to the labor market. The price of labor is taken as the real wage, which is the wage adjusted for inflation; the symbol used to represent the real wage is the Greek

letter omega,  $\omega$ . The supply curve is drawn as upward sloping, though steep, to reflect studies showing that the quantity of labor supplied at any one time is nearly fixed. Thus, an increase in the real wage induces a relatively small increase in the quantity of labor supplied. The demand curve shows the quantity of labor demanded at each real wage. The lower the real wage, the greater the quantity of labor firms will demand. In the case shown here, the real wage,  $\omega_e$ , equals the equilibrium solution defined by the intersection of the demand curve  $D_1$  and the supply curve  $S_1$ . The quantity of labor demanded,  $L_e$ , equals the quantity supplied. The employment level at which the quantity of labor demanded equals the quantity supplied is called the natural level of employment. It is sometimes referred to as full employment.

Even if the economy is operating at its natural level of employment, there will still be some unemployment. The rate of unemployment consistent with the natural level of employment is called the **natural rate of unemployment** (to be illustrated in class). Business cycles may generate additional unemployment.

Figure 1: Natural rate of Employment

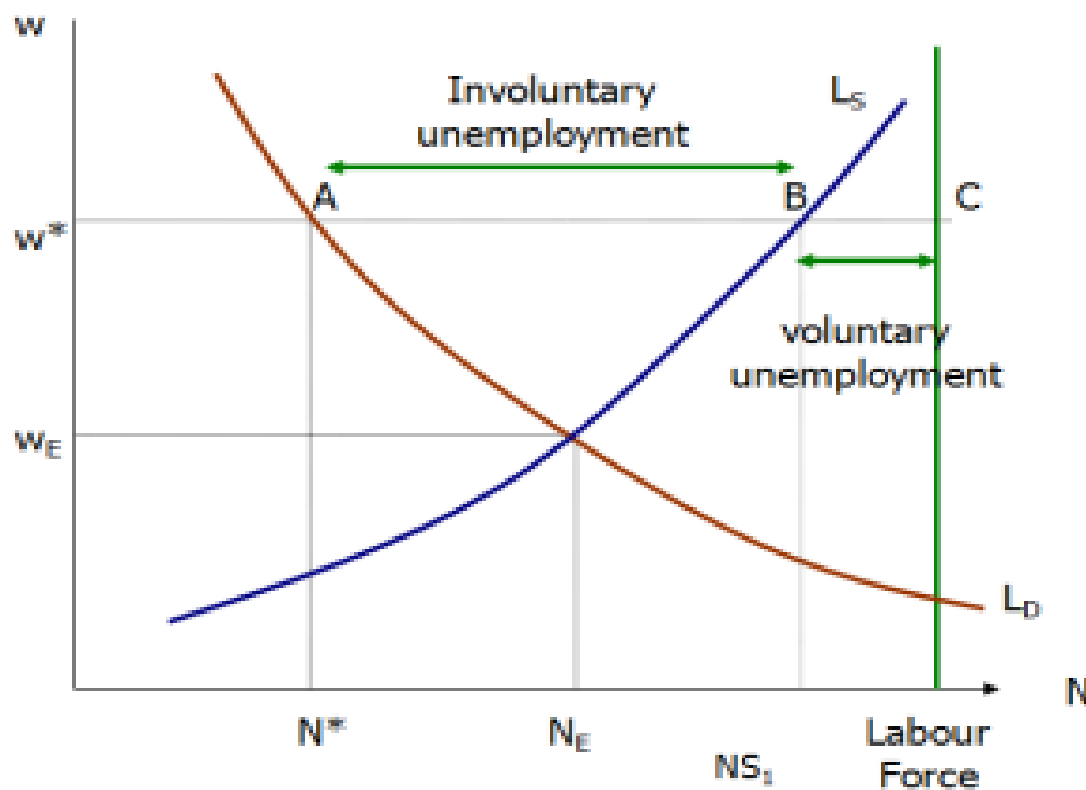


## Involuntary Vs Voluntary unemployment

**Involuntary unemployment** occurs when a person is willing to work at the prevailing wage yet is unemployed.

whereas **Voluntary unemployment** is where workers choose not to work because their reservation wage is higher than the prevailing wage.

Figure 2: Involuntary vs Voluntary Unemployment



## Keynesian vs Classical school of thought on unemployment

**Classical theory of unemployment** affirms unemployment depends on the level of real wages. It occurs when real wages are fixed over the equilibrium level because of rigidities provoked by minimum-wage policies, union bargaining or effective salaries. Classical unemployment is sometimes known as **real wage unemployment**. Advocate for a free-market system to clear markets and restore equilibrium as a solution to unemployment.

**Keynesians and New-Keynesianism** declare employment and aggregate demand is what determines the real wage. Consequently, real wage cannot be considered as a mechanism to adjust employment anymore but labor demand does. Keynes argued that inadequate aggregate demand leads to declines in firms' demand labour which consequently results in prolonged periods of high unemployment. Advocates government intervention to stimulate AD in order to address unemployment.

Figure 3

## **Types of Unemployment**

### **1. Frictional Unemployment**

This type of unemployment occurs in the short-run.

Even when the quantity of labor demanded equals the quantity of labor supplied, not all employers and potential workers have found each other. Some workers are looking for jobs, and some employers are looking for workers. During the time it takes to match them up, the workers are unemployed. Unemployment that occurs because it takes time for employers and workers to find each other is called frictional unemployment.

The case of University graduates engaged in job searches is a good example of frictional unemployment. Those who did not land a job while still in school will seek work. Most of them will find jobs, but it will take time. During that time, these new graduates will be unemployed. If information about the labor market were costless, firms and potential workers would instantly know everything they needed to know about each other and there would be no need



for searches on the part of workers and firms. There would be no frictional unemployment. But information is costly. Job searches are needed to produce this information, and frictional unemployment exists while the searches continue.

### **Solutions to frictional unemployment**

- ✓ The government may attempt to reduce frictional unemployment by focusing on its source: information costs. Many state agencies, for example, serve as clearinghouses for job market information. They encourage firms seeking workers and workers seeking jobs to register with them. To the extent that such efforts make labor-market information more readily available, they reduce frictional unemployment.
- ✓ Governments can provide subsidies to private job agencies to reduce the information costs of hiring and job seeking.
- ✓ Public spending on transport infrastructure to reduce the transport costs of job seeking that are deterrent to job searching.
- ✓ Reduction of unemployment benefits to encourage workers to actively seek for work.

## **2. Structural Unemployment**

Another reason there can be unemployment even if employment equals its natural level stems from potential mismatches between the skills employers seek and the skills potential workers offer. Every worker is different; every job has its special characteristics and requirements. The qualifications of job seekers may not match those that firms require. Even if the number of employees firms demand equals the number of workers available, people whose qualifications do not satisfy what firms are seeking will find themselves without work. Unemployment that results from a mismatch between worker qualifications and the characteristics employers require is called **structural unemployment**.

Structural unemployment emerges for several reasons.



- ✓ Technological change may make some skills obsolete or require new ones. The widespread introduction of personal computers since the 1980s, for example, has lowered demand for typists who lacked computer skills.
- ✓ Structural unemployment can occur if too many or too few workers seek training or education that matches job requirements. Students cannot predict precisely how many jobs there will be in a particular category when they graduate, and they are not likely to know how many of their fellow students are training for these jobs. Structural unemployment can easily occur if students guess wrong about how many workers will be needed or how many will be supplied.
- ✓ Structural unemployment can also result from geographical mismatches. Economic activity may be booming in one region and slumping in another. It will take time for unemployed workers to relocate and find new jobs. And poor or costly transportation may block some urban residents from obtaining jobs only a few miles away.

### **Solutions to Structural unemployment**

- a. Public policy responses to structural unemployment generally focus on job training and education to equip workers with the skills firms demand.
- b. The government publishes regional labor-market information, helping to inform unemployed workers of where jobs can be found.
- c. Public spending on transport infrastructure to reduce geographical immobility of labour and allow workers to commute for jobs in farther geographical regions from where they are currently located.
- d. Housing grants and provision of low cost housing to encourage workers to take on jobs in geographical areas that are farther away.

Although government programs may reduce frictional and structural unemployment, they cannot eliminate it. Information in the labor market will always have a cost, and that cost creates frictional unemployment. An economy with changing demands for goods and services, changing technology, and changing production costs will always have some sectors



expanding and others contracting—structural unemployment is inevitable. **An economy at its natural level of employment will therefore have frictional and structural unemployment.**

### 3. Cyclical Unemployment

Of course, the economy may not be operating at its natural level of employment, so unemployment may be above or below its natural level.

**Cyclical unemployment** is unemployment in excess of the unemployment that exists at the natural level of employment.

Cyclical unemployment occurs with changes in economic activity over the business cycle.

During an economic downturn, a shortfall of demand for goods and services results in a lack of jobs being available for those who want to work. Businesses experiencing weaker demand might reduce the amount of people they employ by laying off existing workers, or hiring fewer new workers. As a result, people looking for work will also find it harder to become employed. The opposite situation occurs when demand strengthens.

Cyclical unemployment is often described as being medium term in nature (one to 12 months).

An increase in cyclical unemployment might suggest the economy is operating below its potential. With more people competing for jobs, businesses might offer lower wage increases, which would contribute to lower inflation.

#### **Solutions to cyclical unemployment**

Policies that stimulate aggregate demand can help reduce this type of unemployment (because businesses experiencing stronger demand are likely to employ more people) such as;

- ✓ Expansionary monetary policy; e.g, reduction of the bank rate.





- ✓ Expansionary fiscal policy; e.g, reduction of income taxes and corporation taxes; increasing government spending towards stimulants for aggregate production by productive sectors.

### **Other Types of Unemployment**

There are some other types of unemployment that are also important to consider. In particular, the underemployment rate can be thought of as a complementary indicator to the unemployment rate when thinking about conditions in the labour market.

- 4. Disguised unemployment: Developing countries, common agricultural sector characterised by low or zero MP.**
- 5. Underemployment** occurs when people are employed, but would like and are available to work more hours. There are two categories of underemployed people. First, part-time workers who would prefer to work additional hours. Second, people who usually work full time, but are currently working part-time hours. Underemployment rates are generally higher among groups that have a larger proportion of people working part time, such as females, younger workers and older workers.
- 6. Hidden unemployment** occurs when people are not counted as unemployed in the formal labour market statistics, but would probably work if they had the chance. For example, someone might have looked for work for a long time, given up hope and stopped looking, but still wish to work. (These people are sometimes referred to as '**discouraged workers**'.)
- 7. Seasonal unemployment** occurs at different points over the year because of seasonal patterns that affect jobs. Some examples include agricultural workers for harvest and holiday-related jobs (e.g tourist jobs).



### **Classical school of thought on Unemployment**

- The crucial assumption driving is the full flexibility of nominal wage growth, and prices
- Classical AS curve
- Aggregate output and employment growth rates always adjust to “natural” rates of growth.
- Advocate for a free-market system
- Unemployment is a temporary short-term problem that arises due to disequilibrium in the labour market

### **Keynesian school of thought on unemployment**

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- Nominal wages and prices are sticky downwards
- Short run AS
- Advocates for government intervention to stimulate AD *i.e*, expansionary fiscal policies
- Unemployment is involuntary and can be long term problem

### **Illustrations of the two theories shown in class**

#### **Exercise**

Familiarise yourself with Uganda’s status of Unemployment, as published in the 2021 Statistical Abstract. Download with the link below:

[https://www.ubos.org/wp-content/uploads/publications/01\\_20222021\\_Statistical\\_Abstract.pdf](https://www.ubos.org/wp-content/uploads/publications/01_20222021_Statistical_Abstract.pdf)

