

MICROECONOMICS AND POLICY ANALYSIS - U8213
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Class Notes - Spring 2001

Unemployment

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Reading: Ehrenberg, Chapter 16

What is unemployment and how do we measure it?

The size of the labor force:

Those currently employed + those who are unemployed but looking for work

The Unemployment Rate = $\frac{\text{The number unemployed but looking}}{\text{The total number in the labor force}}$

Limitations:

- 1) This rate excludes people who aren't part of the labor force because they gave up looking.
- 2) This rate tells us nothing about the quality of work or the types of jobs people have.
- 3) Doesn't talk about the welfare or wellbeing of those unemployed
- 4) A large proportion of the population not in labor force so they won't be counted in the unemployment rate

Stock vs. Flow

Unemployment is a stock measure not a flow measure. It is the total number, a proportion of the labor force at a point in time. The unemployment rate may stay the same but may not include the same individuals. People flow in and out. These flows are important.

Types of Flows:

The number of workers moving from unemployment to employment

The number of workers moving from employment to unemployment

Examples:

In 1998 the flow from unemployment to employment was 1.8 million.

In 1998 the flow from employment to unemployment was 1.6 million.

- 1) The size of flows may be larger than the net flows
- 2) Unemployment results from the change in flows

Types of Unemployment

- 1) **Frictional Unemployment** (Ehrenberg, p. 566) - Unemployment arising when you are in transition between jobs. This will always exist while people look for jobs - it is inevitable. This is search and matching unemployment - a symptom of transition.

To have zero frictional unemployment you would need:

- 1) Perfect and complete information on all jobs
- 2) People who were unemployed would need to accept the first offer

These conditions are unrealistic and undesirable. Although the Internet has increased the flow of information somewhat frictional unemployment will always exist.

How long individuals are will to search depends upon wealth, time, current benefits, etc.

- 2) **Structural Unemployment** (Ehrenberg, p. 567) - Based on the structure of the economy. The jobs that need to be filled and those available to fill them do not match. There is a mismatch of skills and an imbalance among sectors of the economy. This can be across occupations – those unemployed work in textile industry, but the demand is in computers. Or the imbalance can be across geographical areas – there are jobs in California, but people could be losing jobs in another part of the country. This results in migration. Possible solutions include retraining, migration, immigration, and government involvement.
- 3) **Seasonal Unemployment** (Ehrenberg, p. 581) – unemployment due to cyclical changes in employment throughout the year. For example, agricultural work is high during planting and harvest time and low during other parts of the year. Also, construction work is less during the snowy months in the Midwest states of the U.S.

The problems with unemployment (economist standpoint):

It is hard for economists to explain why structural unemployment exists using standard theory. If you believe there are no market imperfections then only frictional unemployment should exist and you cannot explain structural unemployment.

The demand for labor should equal the supply of labor and unemployment - the excess supply of labor should decrease wages until unemployment vanishes. The market equilibrium precludes structural unemployment.

Then why does structural unemployment arise?

- 1) High frequency trends in macroeconomic variables - shifts in importance of one sector of employment to another.
- 2) Government policies – can increase or decrease unemployment

Examples:

- Minimum wage can increase unemployment
 - Unemployment insurance causes people to increase time between jobs. In effect, it increases wage if unemployed and therefore makes searching for a job more attractive than without the insurance. Two implications:
 - Tends to increase frictional unemployment
 - Increases quality of job found
- 3) Wage rigidity – anything that causes inflexibility in the wage rate will affect unemployment. Any institution that prevents wages from flexibly moving up or down from labor market pressure

What leads to wage rigidity?

- Negotiated contracts between firms and unions – sometimes unions would voluntarily lower wages to avoid losing jobs
- Government regulations