Setting the Stage: The Conventional Approach to Exploring the Causes and Consequences of Unemployment

Below is a full set of questions and prototype answers to guide an instructor in establishing for students the conventional perspective on the causes and consequences of unemployment. This knowledge is necessary as a means of establishing the benchmark, with economics as the core discipline, for an interdisciplinary exploration of this topic.

Q. What analytical framework do economists use to determine the equilibrium level of aggregate output and price?

> A. Aggregate supply and demand.
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> Let's set out this graphical model (Figure 1-A). Suppose the economy is in both short-run and long-run equilibrium at point A so the economy is operating at full employment. Moreover, let's label the equilibrium level of output (i.e., income) as Y_A^*(the * denotes the full employment level of income and output), and the price level as P_1.

Q. At the full employment equilibrium is there any joblessness or unemployment?

> A. Yes, even though the quantity of aggregate demand equals the quantity of aggregate supply in the short-run and in the long-run at P_0 there is still some frictional unemployment.

Q. What is frictional unemployment, and why are some individuals frictionally unemployed?

> A. People searching for work, for whom a job exists, but who are yet to make a match with an employer are frictionally unemployed. This situation arises because employers searching for workers recognize that workers are heterogeneous (i.e., they differ) and are attempting to find the best worker which takes time. In addition, persons seeking work understand that firms are heterogeneous and it takes time to search available employers for one offering a set of job characteristics considered best.

Q. What analytical framework do economists use to determine the equilibrium level of employment and real wages?

A. Marginal Product of labor

Let's set out this graphical model (see Figure 2-A) if the capital stock is K_0 (recall that the level of K determines the height of the MP_L curve). Since the level of employment is L_A then if firms are maximizing profits the real wage paid to labor is $w_{0/}P_0$.

Q. What development would lead to a downward shift in the aggregate demand curve?

A. A decline in aggregate spending, say due to a decline in one form of spending with other types of expenditures held constant. Let's suppose there is a decline in investment (I) spending due to firms holding a less optimistic view of the future leading to a reduction in profit expectations.

Let's draw the impact of this development on Figure 1-A.

Q. What is the impact, if any, of the decline in aggregate demand on aggregate income and employment?

A. Consider Figure 1-A. If aggregate demand falls, at P_0 there is now a surplus of goods and inventories begin to build up. Inventories are costly to maintain, so firms begin to reduce prices and a new equilibrium is established at Point B. Relative to Point A, price has fallen to $P_{1\,<}\,P_0$ and output and income have declined to $Y_{B\,<}Y_A^*$. Recall that as price falls, revenue declines and firms become less profitable which provides an impulse for managers to cut production; and they do this in the short-run by reducing their use of labor. Moreover, since output is now below the full employment level the economy is in a recessionary. The decline in income that reveals the magnitude of the recession - represented by the difference between Y_A^* and Y_B - is called the *recessionary gap*. Now even though everyone who wants to work at price level P_1 has been offered a job there are persons capable of working but there are no jobs for them to fill because of the low level of income – they are cyclically unemployed.

Q. What is the impact, if any, of the decline in the aggregate price level on the level of employment in Figure 1-B?

A. Consider Figure 1-B. If price rises the real wage falls to $w_{0/}P_1 < w_{0/}P_0$. The MP_L (at L_A) is $< w_{0/}P_1$ so L_A is no longer profit maximizing. However, if employment falls to L_B the firms are once again maximizing profits for MP_L (L_B) is $= w_{0/}P_1$.

Q. What is the economic cost of unemployment to society and are there costs to individuals?

A. The cost to society is the lost output, Y_A^* - Y_B (i.e., the recessionary gap) - associated with employment falling to L_B from L_A (see Figure 1-A). If these persons are unemployed long enough their skills may begin to depreciate and they will become less productive which is also a concern.

Q. How long will the recession last if there is no policy intervention on the part of government?

A. The recession will persist until unemployed workers offer to work for lower wages - and when this development occurs it results in employers reducing wages for all workers. Ultimately, wages must fall enough to reestablish the original real wage and level of employment at which point there is once again full employment. Thus, the wage must fall to $w_1 < w_0$ so that $w_{1/}P_1 = w_{0/}P_0$ and employment returns to L_A (see Figure 1-A). If the wage declines but not all the way to w_1 then the real wage will remain above the original real wage and employment will fall short of full employment and their will be continued pressure from the remaining unemployed to reduce wages further; which will eventually occur.

Q. What is the impact of the decline in wages to w_1 on the aggregate product market?

A. When the wage falls, and costs for firms fall which improves profits, firms have an incentive to increase output and in the short run (i.e., capital and technology are fixed) firms must increase employment to expand output. The increase in output associated with the rise in employment due to the lower wage shift AS_1^{SR} to the right and a new short-run equilibrium, that is also a full employment equilibrium – is established at point C on Figure 1-A. Notice that $Y_C^*=Y_A^*$. However the increase in output also drives the price down to P_2.

Q. If the unemployed are slow in deciding to work for lower wages, leading to a persistent recession, is there a way that policy makers can reduce the duration of the recession? If so, how would they do this and what are the potential mechanisms?

A. Policy makers can engage in activities that lead to greater spending, thereby shifting the aggregate demand curve back to its original position, before the wage level falls. One way they can do this is by engaging in an expansionary fiscal policy – either increase government spending or cut income taxes leading to greater disposable income in the hands of consumers causing them to raise their level of consumption. Alternatively, policy makers at the Federal Reserve could opt to increase the money supply - by buying bonds from banks – leading to a decline in interest rates and a rise in investment spending on the part of firms and an increase in the consumption of big ticket items such as cars that household usually purchase with borrowed money; this is referred to as expansionary monetary policy.

Q. Are there other perspectives within the discipline of economics that have been offered to explain joblessness that should be brought into a comprehensive examination of unemployment and that lend themselves to the inclusion of insights from other disciplines?

A. The Dual or Segmented Labor Market Theory (Doeringer and Piore, 1971) along with Marxist conceptualizations of the motives driving capitalists each offer perspective on the factors promoting work and leading to unemployment that challenge conventional neoclassical thinking to account for social elements that are ignored and when accounted for give a more complete characterization of employment dynamics and vulnerability to the psychological consequences of joblessness.

Q. What are the central tenants of Dual Labor Market Theory?

A. Dual labor market theory posits that the economy is characterized by two sectors- a *primary sector* and a *secondary sector* – where features of work differ markedly and that worker mobility between the sectors is severely limited in part due to inequalities embedded in society along with discriminatory practices. The primary sector features jobs with high wages, good working conditions, employment stability, and chances for training and promotion. Secondary sector employment is distinguished by poor compensation and working conditions, high turnover, and few opportunities for skill development and advancement. The theory has been extended, and renamed Segmented Labor Market Theory, to allow for an *intermediary sector* that is typified by mediocre jobs that combine qualities that are attractive with others that are undesirable.

Occupations that require high skill levels typically provide work in the primary sector. In these occupations there is a wide array of work often referred to as a *job ladder*, and workers are viewed as heterogeneous. Promotion up the ladder at a given firm or to higher level positions within the occupation but at other firms is presumed to be based on merit. Thus, workers in the primary sector can experience upward economic mobility over the course of their careers by changing jobs within a given firm or by changing employers.

Jobs in occupations that demand little academic training are the mainstay of the secondary sector. Employers view workers in this sphere as homogeneous and hence easily substitutable for one another. Job ladders are very short in this arena and workers who are employed in this sector find that employers are leery of offering them primary sector work even if they accumulated the request skills while engaged in secondary sector work.

The distribution of workers across primary and secondary sector jobs is not random. Female, minority, and immigrant workers along with young labor force participants are much more likely than native born mature white male workers to end up in bad or mediocre jobs. The mechanisms that disadvantage these workers range from simple discrimination (e.g., firms that will not hire blacks or women for certain jobs) to more institutional and structural barriers, such as a lack of access to training and education, inflexible work hours, or a lack of ties to social networks that can link them to primary jobs (see Granovetter, 1973). Moreover, immigrant workers often face legal restrictions on where they can work.

At first glance, it appears that the Dual Labor Market Theory suggests that secondary sector workers are less secure than primary sector employees. Thus, workers in the secondary sector would be more susceptible than primary sector employees to the adverse psychological consequences of joblessness, especially since globalization has resulted in the off-shoring of jobs that are disproportionately located in the secondary sector. However, recent labor market developments have compromises job security in the primary sector. For instance, technological change has allowed many primary sector jobs to be restructured into secondary sector work. In addition, to reduce costs and boost profits many firms are making greater use of temporary and contract workers which effectively permit them to downgrade jobs from the primary to the secondary. Each of these developments fosters increased insecurity among the employed located in the primary sector. Moreover, workers I the primary sector may be highly attached to work, and have ambitious career expectations, so like those in the secondary sector, they are vulnerable to the emotional consequences of joblessness.

Q. What are the central tenants of a Marxist view on the causes of unemployment?

A. Marx asserted that a fundamental feature of capitalist society is a division of interest between capital and labor. In his view competition provides an impulse for capitalists to constantly seek ways to reduce production costs which is typically accomplished by utilizing labor-displacing machinery or other means of securing the same output with less labor. The resulting unemployment creates a supply of potential workers – which Marx dubbed the "*industrial reserve army*" - who stand ready to be used by employers. This group has little power or leverage in negotiating over work and compensation because of the wide gap in political power and economic wealth that favors employers. Indeed, to encourage employers to hire them, members of the industrial reserve offer to work for low wages and are flexible employees who bend to the wishes of management. Thus, they essentially discipline existing employees to accept low pay and to work where needed, ensuring the profitability of existing ventures and allowing capitalists to take advantage of technological changes opening new markets. According to Marx capitalism fosters tensions between the jobless and those with jobs as well as between employers and potential employees. In addition, the psychological harm the jobless experience is beneficial to the capitalist process, since it helps to weaken workers and promote the interests of capitalist which generates subsequent job opportunities. Essentially, the inner logic of the capitalist mode of production routinely generates joblessness and insecurity in the population, exposing them to poor psychological well-being.