Unemployment: Forced or voluntary? Financial crisis revives an old debate

By Miles Corak

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Arthur Cecil Pigou made lasting contributions to the science of economics, but for macroeconomists of a certain generation, he will always be considered a laughingstock.

Professor Pigou taught at Cambridge University during the 1920s and 1930s, and had the misfortune of making a cameo appearance in the opening chapters of what is arguably the most influential economics book of the 20th century, *The General Theory of Employment, Interest, and Money*, written with eloquence, and at times a very caustic pen, by his colleague at the same university, John Maynard Keynes.

Mr. Pigou's big mistake was to suggest that the unemployed themselves were to blame for their predicament. To Mr. Keynes, the notion that the persistently high unemployment rates of the Great Depression were in some sense voluntary was worthy of scorn and ridicule.

The collapse of Lehman Brothers five years ago this month has unleashed, in our times, the same battle of ideas that animated the 1930s – and a good deal of this debate involves the correct way to interpret unemployment. The case for austerity depends very much on your interpretation.

Canada's Minister of Finance, Jim Flaherty, has moved the country's fiscal policy between these views: Basing an October, 2007 Economic Statement on the economics of full employment; then introducing government make-work projects by offering a view of unemployment as involuntary in November, 2008 just after the Lehman Brothers bankruptcy; and then, by 2010, shifting back to a view of unemployment as structural, in order to buttress the elimination of budget deficits as a policy priority.

For Mr. Pigou, and his modern-day followers, unemployment is simply an excess supply of labour caused by policies or attitudes preventing wage rates from adjusting as smoothly as prices do in any well-functioning market. If the unemployed were willing to work at lower wage rates, the problem would simply disappear. More government spending will not create jobs; it's only going to compete with the private sector and shift bargaining power to workers. Before you know it, a wage-price spiral will lead to higher inflation.

Mr. Keynes saw in the unemployment rate data of the 1930s what they show today: A sharp runup that has persisted for years and years. Can this possibly be voluntary?

In the 17 countries that make up the euro zone, the unemployment rate shot up in late 2008 and, even more remarkably, has actually been rising for the past two years. Things are not much better in the United Kingdom, with virtually no progress made in reducing the unemployment rate during the past four years. And nowhere has unemployment returned to pre-recession levels, not even in countries benefiting from the bonus of a commodity price boom: Not Australia, not Canada.

To Mr. Keynes, this kind of unemployment is involuntary – unleashed by a locking-up of the financial system, and sustained by continued pessimism. Tightening the public purse just makes things worse.

Ironically, Keynesian economics counsels us to do more, not less, of what got us into the mess in the first place: To collectively borrow and spend in the hope of giving the private sector a kick-start, generating jobs and incomes directly through government spending, which then induces more hiring and another round of spending, hiring, and incomes.

Mr. Keynes longed for the day when economics would be seen as no more controversial than dentistry, a technical science that could fix the bugs in an inherently unstable economic system. He was as much a believer of running surpluses in times of plenty as he was an advocate of deficits in times of depression.

But politics is inherent to budget making, and the time horizon of politicians is often much shorter than the length of a business cycle. The temptation to spend at an unsustainable rate during the boom has historically proved too much for those with an eye on the next ballot.

Not having confidence that governments can run surpluses during economic booms, you can see why some argue for balanced budgets during economic recessions, and try with all their might to convince us that unemployment is all structural.

For if the electorate can't be convinced with the simplistic logic that governments should, like any family, tighten their belts when times are tough, how can they possibly be convinced when the good times roll?

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