

**ECO 407**

**Competing Views in  
Macroeconomic Theory and Policy**

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**Lecture 5**

**Why Is There Unemployment?**

# What Is Unemployment?

- The **labour force** consists of those working-age individuals (aged 15 or older) currently working (the **employed**) plus those who are not working but are actively trying to find a job (the **unemployed**)
  - Those who are neither working nor trying to find work are not considered part of the labour force, i.e., they are considered the **economically inactive** population
- The **unemployment rate** is the percentage of the labour force that is unemployed
  - At **5.7 percent**, the current rate of unemployment is lower than at the start of the Great Recession (but it was **8.7 percent** at the peak of the recession)
  - Presently, about **1.1 million** Canadians are out of work

# Canada: Open Unemployment Rate

## January 1980 to August 2019



**Source:** Tradingeconomics.com / Statistics Canada.

# Canada: Participation Rate

## January 2008 to August 2019



**Source:** Tradingeconomics.com / Statistics Canada.

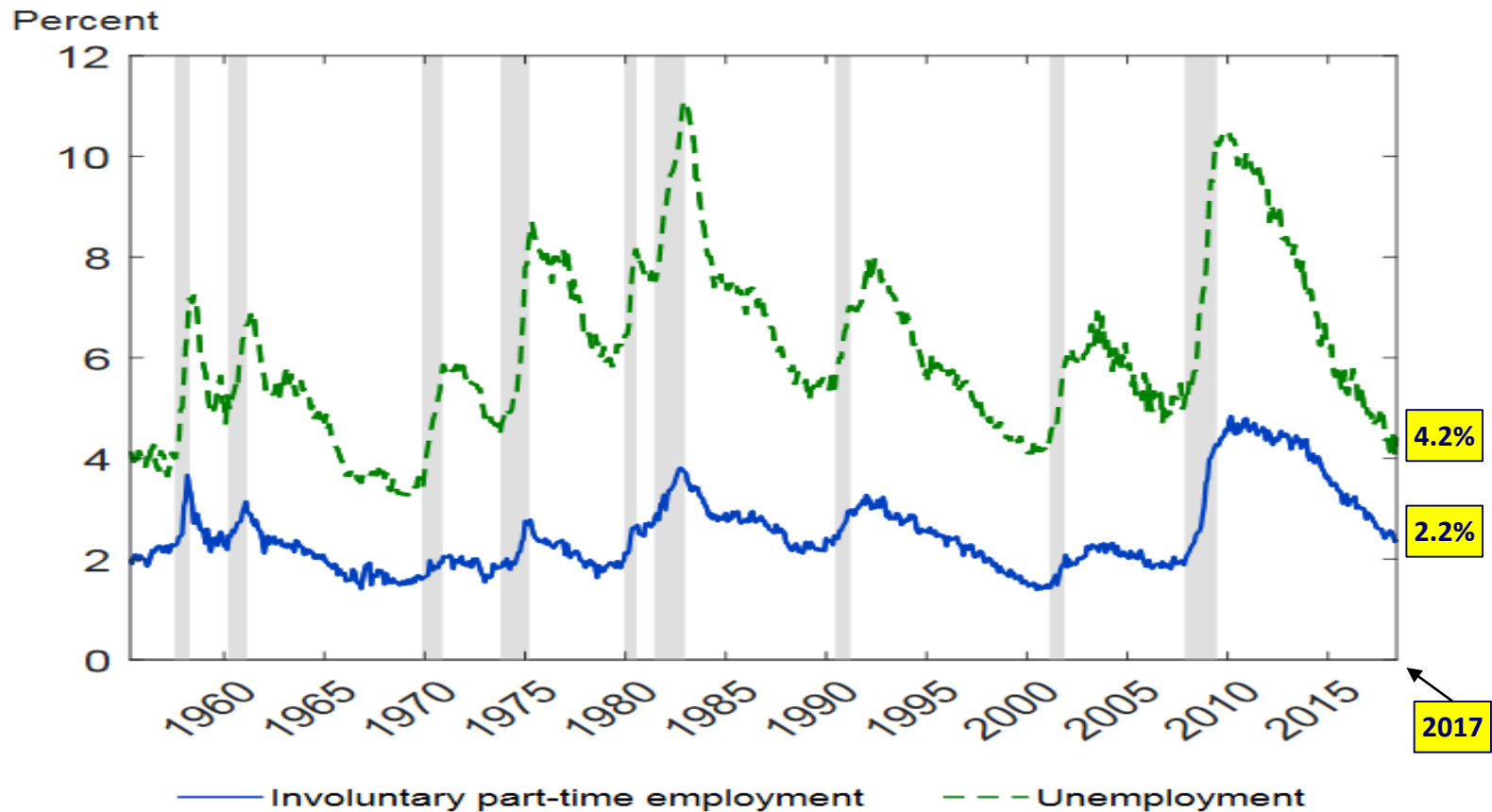
# Recessions and Unemployment

- There have been four major recessions in Canada since the second World War:
  - 1958-60 — rate of unemployment peaked at 7.1 percent
  - 1981-82 — rate of unemployment peaked at 13.0 percent
  - 1990-91 — rate of unemployment peaked at 11.4 percent
  - 2008-09 — rate of unemployment peaked at 8.7 percent
- The first three were ***strategic recessions*** in the sense that they were engineered by the Bank of Canada to reduce inflation (but not the most recent one)
- The ***minimum*** unemployment rate attained in each period of economic expansion tend to differ in each cycle
  - For example, it was 3.4 percent in 1966, 7.5 percent in 1979, 7.5 percent in 1989, and 5.8 percent in 2007

# The Official Measure of Unemployment

- Official measure of unemployment *underestimate* true unemployment
  - It does not include discouraged job searchers (*hidden unemployment*), those waiting for recall or replies, and involuntary part-timers or those overqualified for their jobs (*underemployment*)
  - Correcting for these misses, unemployment rate would have been **8.8 percent** instead of **6.1 percent** in 2008
- A person just reading want ads is considering actively searching for work in Canada but not in the U.S.
  - If the rule in Canada were the same as in the U.S., the rate of unemployment would have been **5.3 percent** instead of **6.1 percent** in 2008

# U.S.: Involuntary Part-time Employment and Unemployment Rates (1955-2017)



**Source:** D. Borowczyk and M.E. Lalé, “The Ins and Outs of Involuntary Part-Time Employment,” Working Paper 9-2018, Department of Economics, Copenhagen Business School, August 2018.

# Unemployment is a Dynamic Phenomenon

- The unemployed is continuously replaced by a similar number of new unemployed → **labour reserve army**
- Unemployment is characterized by high **turnover** and by high **concentration** among a minority of disadvantaged workers
- Unemployment is usually of high-frequency but short duration in North America and the opposite in Europe
  - This might be due to different labour market institutions: employment **flexibility** in North America vs. employment **protection** in Europe
- Unemployment became of much greater duration during the last recession

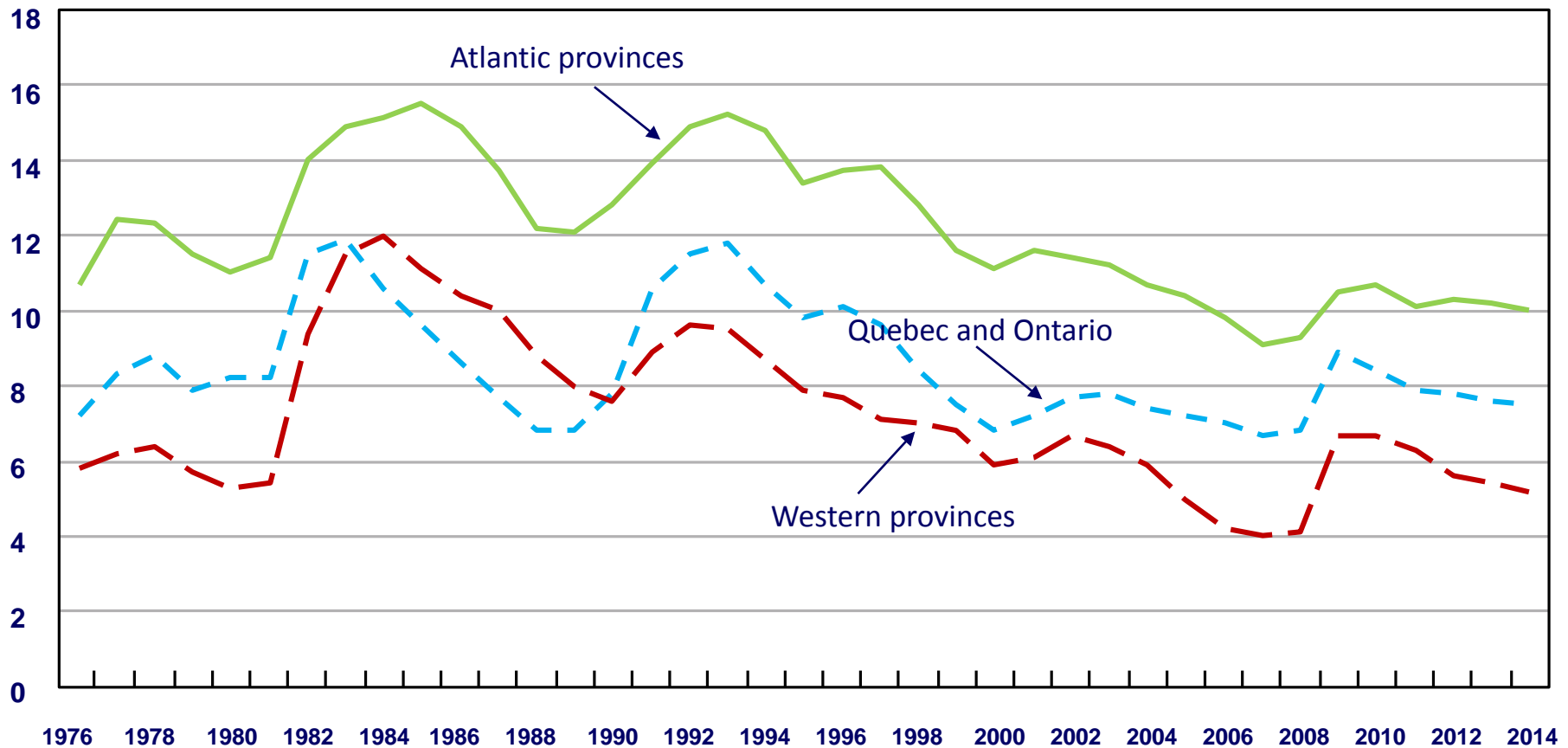


# Pierre Fortin: Characteristics of Canadian Unemployment

- Unemployment is high in winter, and low in autumn
  - Unemployment is higher among young workers and among men
  - Dropping out of high school is bad for employment prospects
  - Regional unemployment decreases from east to west
  - Due to turnover and search, there is always some minimum amount of unemployment
- Above certain level, the *minimum wage* destroys jobs
  - *Employment insurance* increases both employment and unemployment

# Unemployment Rate by Region

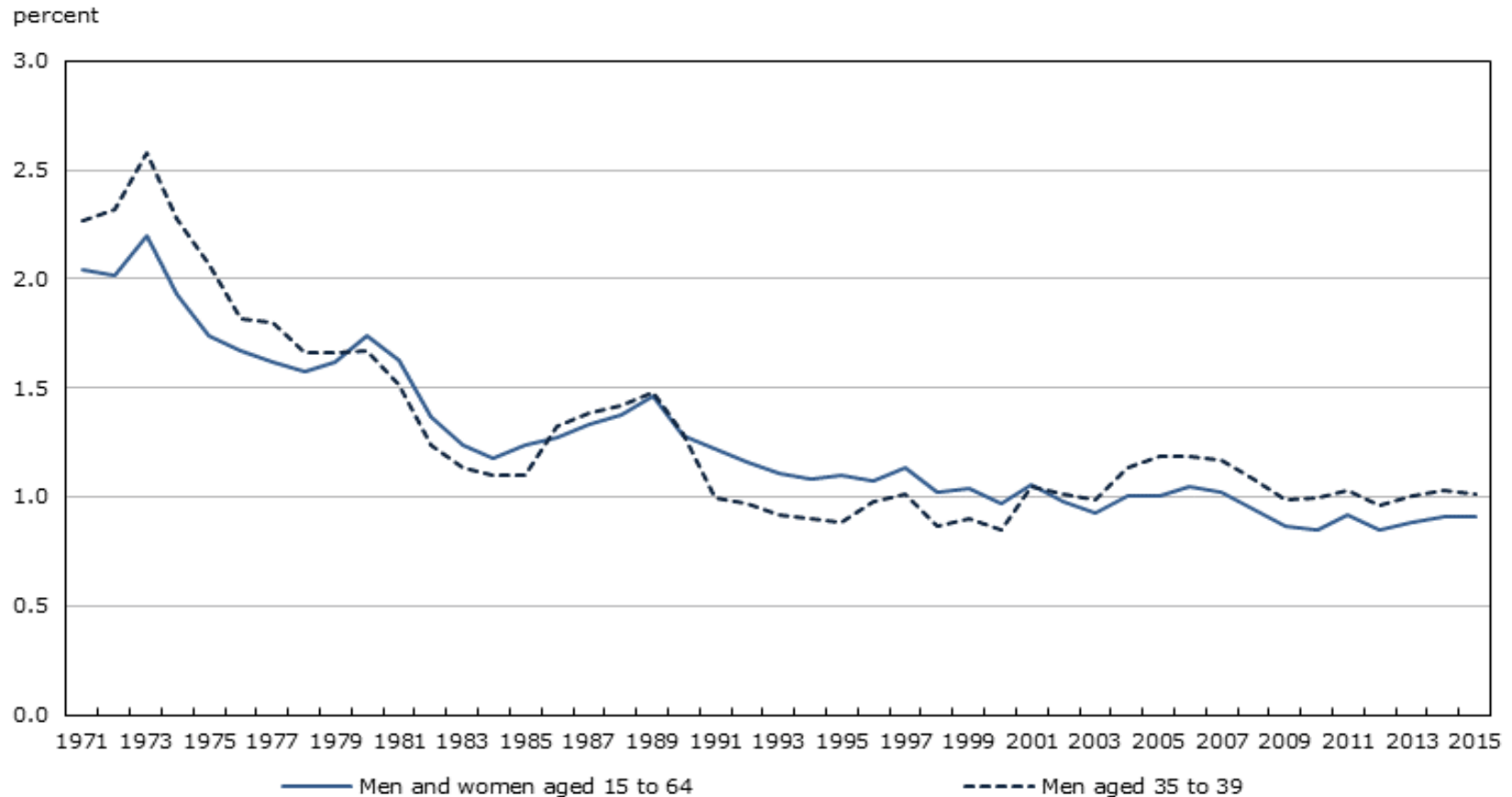
Rate (percent)



**Note:** Western provinces include Manitoba, Saskatchewan, Alberta, and British Columbia.

**Source:** Statistics Canada, Labour Force Survey.

# Inter-Provincial Migration as Percentage of Population



**Source:** R. Morissette, "Barriers to Labour Mobility in Canada: Survey-Based Evidence," Economic Insights No. 076, Statistics Canada, 17 November 2017.

# Alternative Views of Unemployment

- The *orthodox* (or *neoclassical*) view is that unemployment is voluntary and is essentially a *supply-side* phenomenon
  - People *prefer* not to work or it is the result of *rigidities* in the labour market such as minimum wages
- The *heterodox* (or *Keynesian*) view is that unemployment is involuntary and mainly a *demand-driven* phenomenon
  - It is essentially caused by an insufficient *aggregate demand*
  - This view has recently regained popularity among economists as a result of the Great Recession
- The *sociological* view considers unemployment to be a *societal* problem and not a strictly *economic* one
  - The economy must be *embedded* in society

# The Orthodox View

- Neoclassical economists assume that the **labour market** is usually in **equilibrium**, i.e., the demand for labour is equal to the supply of labour
  - They assume that both labour demand and labour supply are functions of the **real wage rate**
- There is **unemployment** because people **prefer** not to work or because there are **rigidities** in the labour market which prevent the wage rate to adjust to the market clearing level
- When negotiating their nominal wages, workers do not know what the general price level will be
  - If they overestimate inflation, they will tend to turn down job offers and unemployment will increase

# The Orthodox View (cont'd)

- Neoclassical economists believe in the existence of a ***non-accelerating inflation rate of unemployment (NAIRU)***
  - If the rate of unemployment is kept below the NAIRU, the rate of inflation will rise
- Neoclassical economists believe that ***market forces*** will push the rate of unemployment toward the NAIRU
  - NAIRU is the only sustainable rate of unemployment
  - No trade-off between the rate of unemployment and the rate of inflation in the long run
- In the absence of labour market rigidities, the NAIRU would be the ***natural rate of unemployment*** (Friedman)
  - The existence of rigidities cause the NAIRU to be above the natural rate of unemployment

# The Orthodox View (cont'd)

- In order to reduce the rate of ***unemployment***, governments should implement policies aimed at reducing labour market ***rigidities***
- These ***rigidities*** include:
  - Minimum-wage laws
  - Overly strong labour unions
  - Employment insurance programs
  - Others laws that protect workers
  - Payroll taxes
- Empirical evidence supporting this view are hard to come
- In their view, expansionary ***fiscal policies*** will have only temporary effects and will cause inflation

# The Heterodox Keynesian View

- Keynesian economists believe that ***unemployment*** arises because of a lack of ***aggregate demand***
  - Therefore, unemployment is essentially ***involuntary***
- Reduction in any of the components of aggregate demand (including ***consumption***) will cause the rate of unemployment to rise
- The higher the ***propensity to consume***, the higher ***aggregate demand*** and, therefore, the lower the rate of ***unemployment***
- But ***consumption*** also depends on ***real wages*** because the overall propensity to consume depends on the ***distribution of income***
  - The ***propensity to consume*** out of ***profits*** is lower than the ***propensity to consume*** out of ***wages***

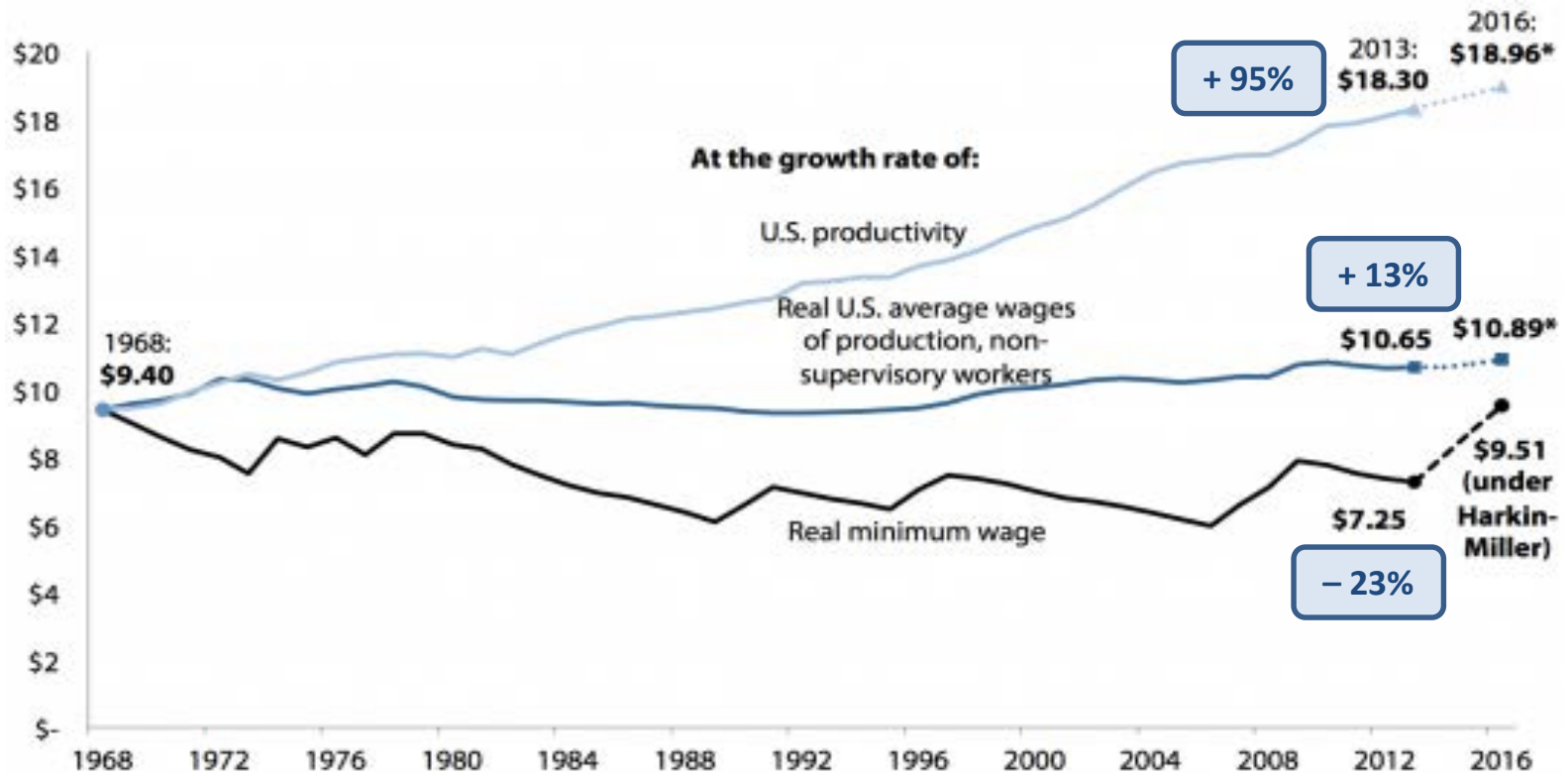


# The Heterodox Keynesian View (cont'd)

- ***Income redistribution*** toward wages will increase the overall propensity to consume
  - Therefore, ***aggregate demand*** and ***employment*** will increase
- Higher ***real wages*** will have a negative impact on ***employment*** only if they cause a reduction in ***investment*** by cutting the profit perspectives of the firms
- As long as the positive effect on consumption overcomes the possible negative effect on investment, higher ***real wages*** will have a ***positive*** effect on ***aggregate demand*** and ***employment***
  - This is in contrast to the ***neoclassical*** view that ***employment*** would fall with increases in ***real wages***

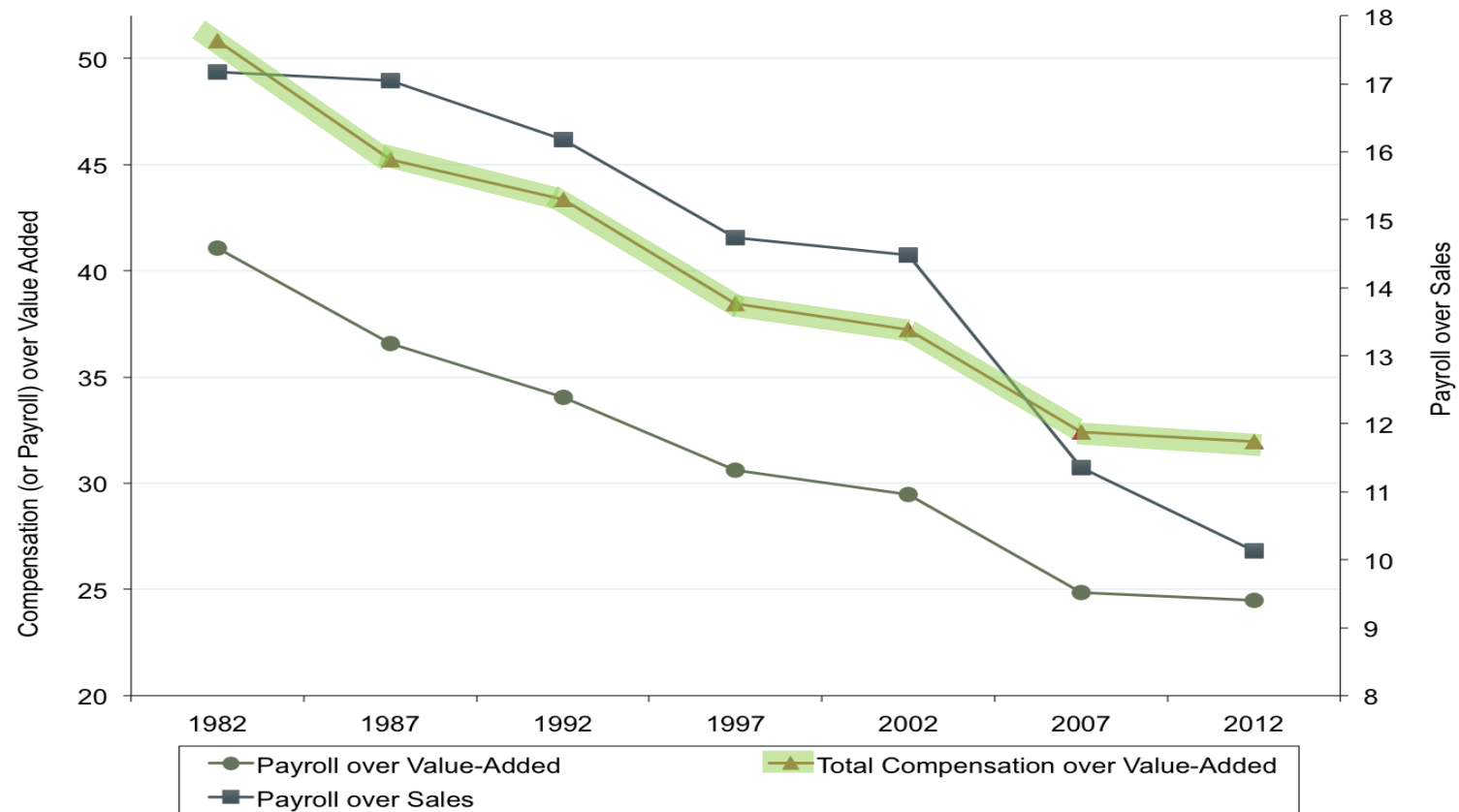
# U.S.: Real Minimum Wage

## 1968-2016, Constant 2013 dollars



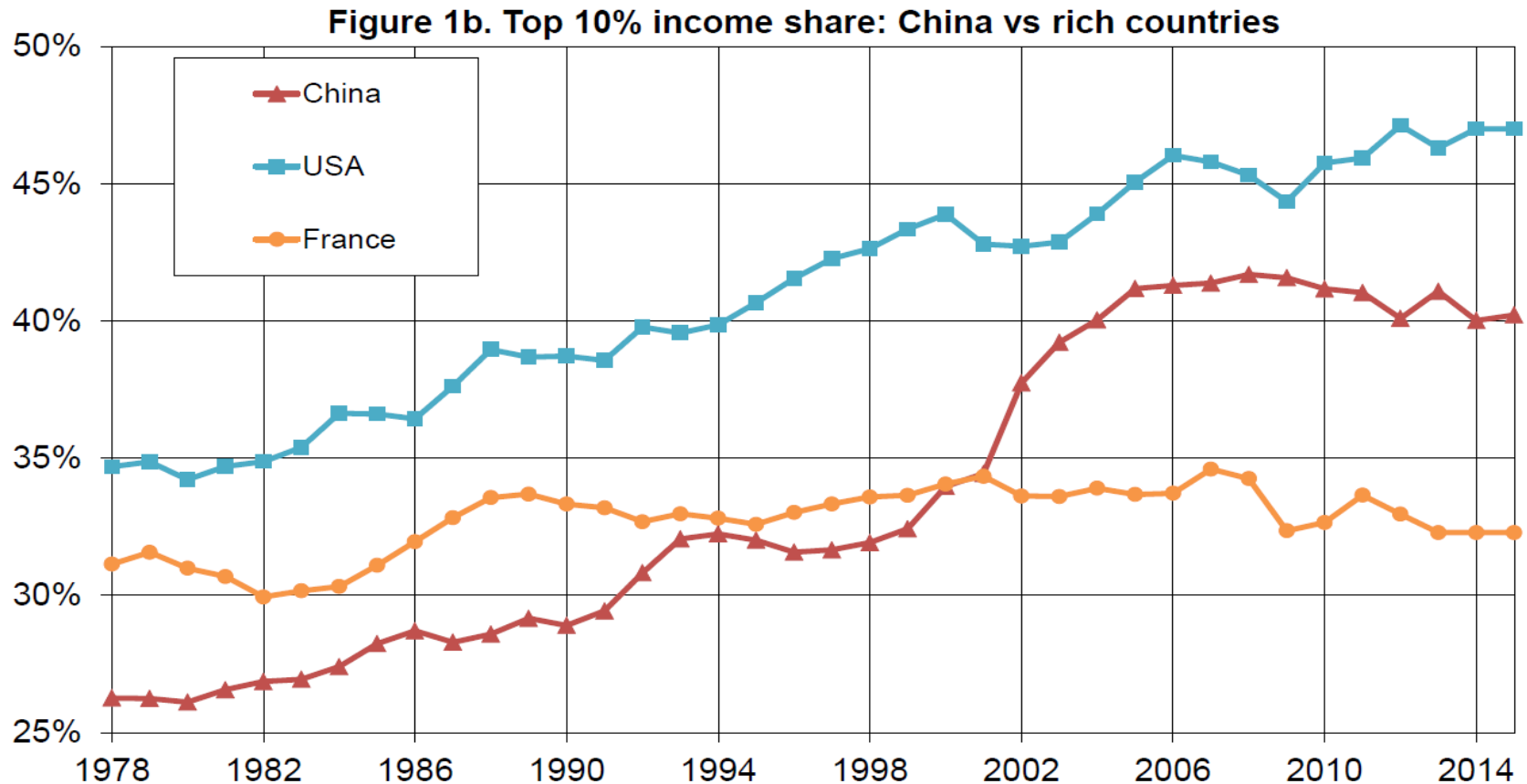
**Source:** David Cooper, "Raising the Federal Minimum Wage to \$10.10 Would Lift Wages for Millions and Provide a Modest Economic Boost," Economic Policy Institute, 19 December 2013.

# U.S.: Share of Labour Income in Manufacturing Sector



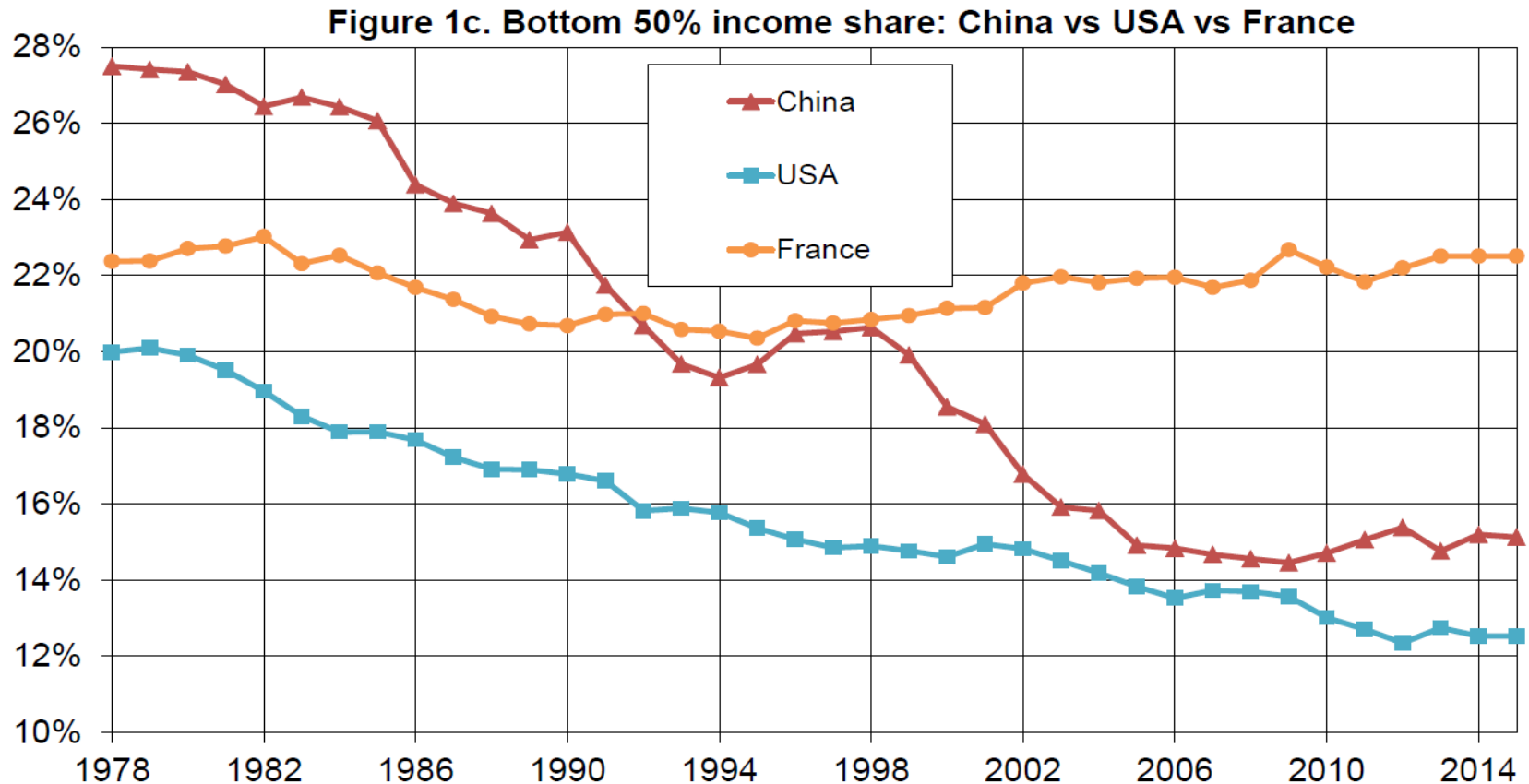
**Source:** D. Autor, D. Dorn, L. Katz, C. Patterson, and J. Van Reenen, “The Fall of the Labour Share and the Rise of Superstar Firms,” IZA Institute of Labor Economics, Discussion Paper Series, IZA DP No. 10756, May 2017.

# Income Concentration (I)



**Source:** F. Alvaredo, L. Chancel, T. Piketty, E. Saez and G. Zucman, "Global Inequality Dynamics: New Findings from WID.world," Working Paper 23119, National Bureau of Economic Research, February 2017.

# Income Concentration (II)

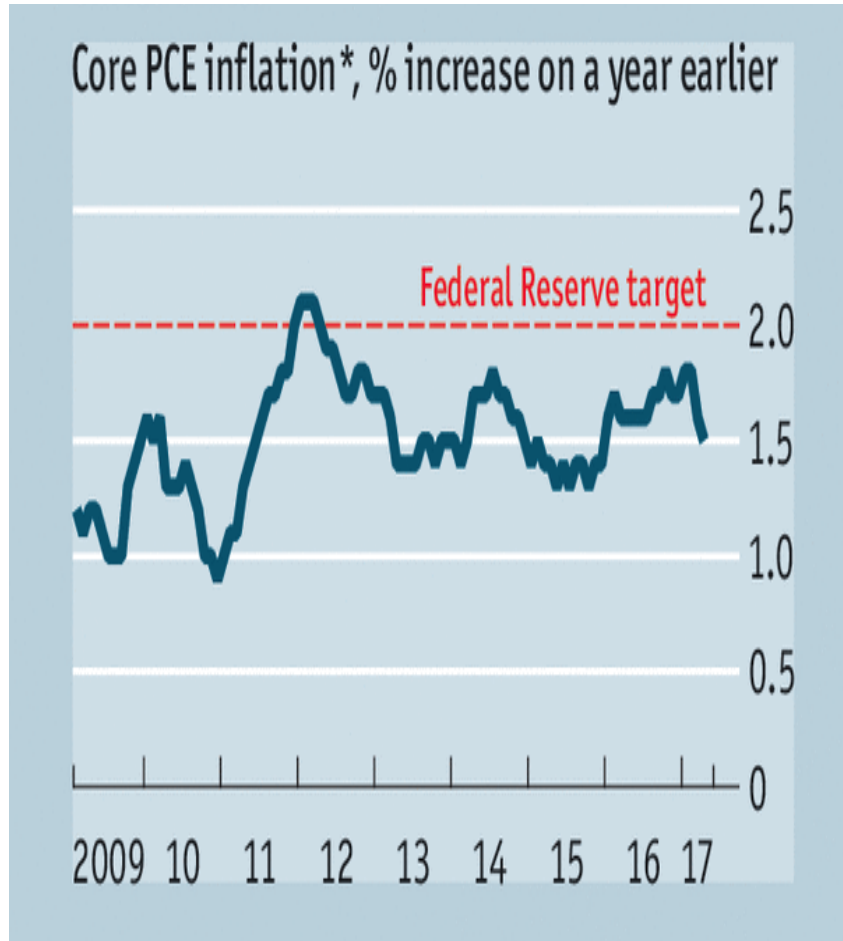


**Source:** F. Alvaredo, L. Chancel, T. Piketty, E. Saez and G. Zucman, "Global Inequality Dynamics: New Findings from WID.world," Working Paper 23119, National Bureau of Economic Research, February 2017.

# The NAIRU and the Keynesians

- Keynesians deny that there exists a unique rate of *unemployment* that can keep the rate of *inflation* steady
    - That is, they reject the *NAIRU* concept
  - They argue that the empirical evidence supporting a vertical long-run *Phillips curve* has been flimsy at best
  - Empirical work of the last 15 years questions the existence of a necessary *trade-off* between *inflation* and *unemployment* rates
    - These studies suggest that lower *unemployment* rates are not accompanied with higher *inflation* rates
- Therefore, *heterodox economists* claim that there is room for a substantial amount of *discretion* in *macroeconomic policy*

# U.S.: The NAIRU and the Evidence



Source: “Finding Phillips”, *The Economist*, June 15, 2017.

# The Sociological View

- The **economy** should be embedded in **society**
  - *Ultimately **society**, not the **economy**, determines how many people are out of work*
- The problem of **unemployment** and **under-employment** stems from three main flaws in the economic system:
  - Misuse of gains in **labour productivity**
  - Employers lack **flexibility** for alternative **work schedules**
  - **Mismatch** between the kinds of jobs supplied by the economy and the kind of jobs that society really needs
- What could be done to eliminate **involuntary** unemployment?
  - Work-time reduction
  - Work sharing
  - Guaranteed jobs



# Some Conclusions

- ***Neoclassical view:***

- The government should attempt to remove all labour ***market rigidities*** in order to let the market determine the rate of unemployment

- ***Keynesian view:***

- The rate of unemployment is determined by the lack of ***aggregate demand*** and the government could implement policies to increase the latter

- ***Sociological view:***

- ***Society*** and not the ***economy*** ultimately determines the rate of ***unemployment***