



## Unemployment and the Labor Market

*A man willing to work, and unable to find work, is perhaps the saddest sight that fortune's inequality exhibits under the sun.*

—Thomas Carlyle

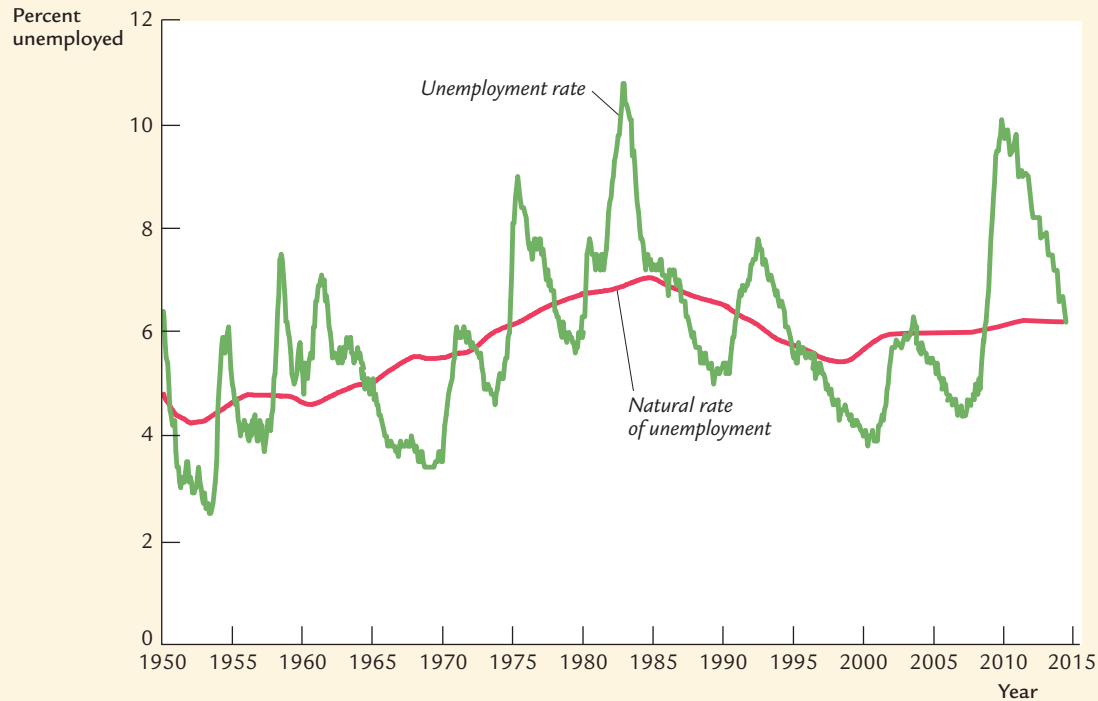
Unemployment is the macroeconomic problem that affects people most directly and severely. For most people, the loss of a job means a reduced living standard and psychological distress. It is no surprise that unemployment is a frequent topic of political debate and that politicians often claim that their proposed policies would help create jobs. While the issue is perennial, it rose to particular prominence in the aftermath of the financial crisis and recession of 2008–2009, when the unemployment rate lingered around 9 percent for several years before drifting down to about 6 percent in 2014.

Economists study unemployment to identify its causes and to help improve the public policies that affect the unemployed. Some of these policies, such as job-training programs, help people find employment. Others, such as unemployment insurance, alleviate some of the hardships that the unemployed face. Still other policies affect the prevalence of unemployment inadvertently. Laws mandating a high minimum wage, for instance, are widely thought to raise unemployment among the least skilled and least experienced members of the labor force.

Our discussions of the labor market so far have ignored unemployment. In particular, the model of national income in Chapter 3 was built with the assumption that the economy is always at full employment. In reality, not everyone in the labor force has a job all the time: in all free-market economies, at any moment, some people are unemployed.

Figure 7-1 shows the rate of unemployment—the percentage of the labor force unemployed—in the United States from 1950 to 2014. Although the rate of unemployment fluctuates from year to year, it never gets even close to zero. The average is between 5 and 6 percent, meaning that about 1 out of every 18 people wanting a job does not have one.

In this chapter we begin our study of unemployment by discussing why there is always some unemployment and what determines its level. We do not study what determines the year-to-year fluctuations in the rate of unemployment until

**FIGURE 7-1****The Unemployment Rate and the Natural Rate of Unemployment in the United States**

There is always some unemployment. The natural rate of unemployment is the average level around which the unemployment rate fluctuates. (The natural rate of unemployment for any particular month is estimated here by averaging all the unemployment rates from ten years earlier to ten years later. Future unemployment rates are set at 5.5 percent.)

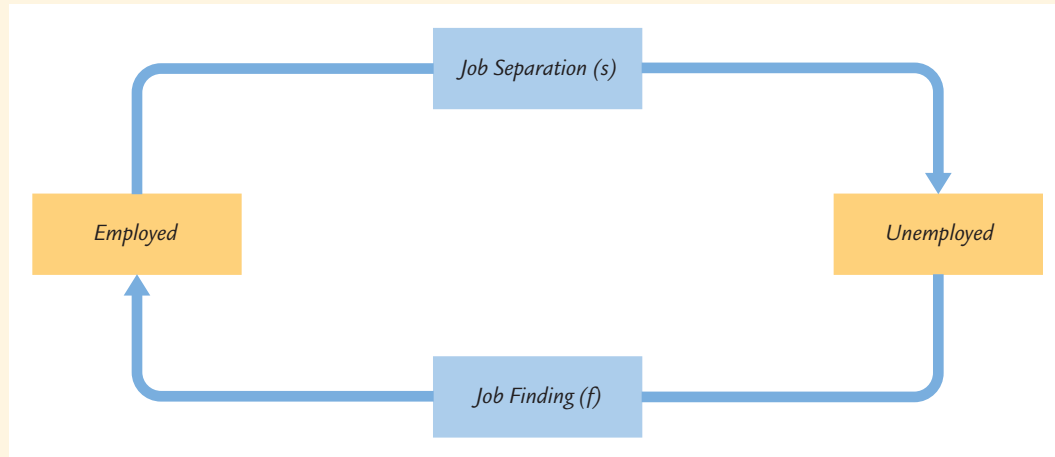
*Data from: Bureau of Labor Statistics.*

Part Four of this book, which examines short-run economic fluctuations. Here we examine the determinants of the **natural rate of unemployment**—the average rate of unemployment around which the economy fluctuates. The natural rate is the rate of unemployment toward which the economy gravitates in the long run, given all the labor-market imperfections that impede workers from instantly finding jobs.

## 7-1 Job Loss, Job Finding, and the Natural Rate of Unemployment

Every day some workers lose or quit their jobs, and some unemployed workers are hired. This perpetual ebb and flow determines the fraction of the labor force

FIGURE 7-2



**The Transitions Between Employment and Unemployment** In every period, a fraction  $s$  of the employed lose their jobs, and a fraction  $f$  of the unemployed find jobs. The rates of job separation and job finding determine the rate of unemployment.

that is unemployed. In this section we develop a model of labor-force dynamics that shows what determines the natural rate of unemployment.<sup>1</sup>

We start with some notation. Let  $L$  denote the labor force,  $E$  the number of employed workers, and  $U$  the number of unemployed workers. Because every worker is either employed or unemployed, the labor force is the sum of the employed and the unemployed:

$$L = E + U.$$

In this notation, the rate of unemployment is  $U/L$ .

To see what factors determine the unemployment rate, we assume that the labor force  $L$  is fixed and focus on the transition of individuals in the labor force between employment  $E$  and unemployment  $U$ . This is illustrated in Figure 7-2. Let  $s$  denote the *rate of job separation*, the fraction of employed individuals who lose or leave their jobs each month. Let  $f$  denote the *rate of job finding*, the fraction of unemployed individuals who find a job each month. Together, the rate of job separation  $s$  and the rate of job finding  $f$  determine the rate of unemployment.

If the unemployment rate is neither rising nor falling—that is, if the labor market is in a *steady state*—then the number of people finding jobs  $fU$  must equal the number of people losing jobs  $sE$ . We can write the steady-state condition as

$$fU = sE.$$

<sup>1</sup>Robert E. Hall, “A Theory of the Natural Rate of Unemployment and the Duration of Unemployment,” *Journal of Monetary Economics* 5 (April 1979): 153–169.

We can use this equation to find the steady-state unemployment rate. From our definition of the labor force, we know that  $E = L - U$ ; that is, the number of employed equals the labor force minus the number of unemployed. If we substitute  $(L - U)$  for  $E$  in the steady-state condition, we find

$$fU = s(L - U).$$

Next, we divide both sides of this equation by  $L$  to obtain

$$f\frac{U}{L} = s\left(1 - \frac{U}{L}\right).$$

Now we can solve for the unemployment rate  $U/L$  to find

$$\frac{U}{L} = \frac{s}{s + f}.$$

This can also be written as

$$\frac{U}{L} = \frac{1}{1 + f/s}.$$

This equation shows that the steady-state rate of unemployment  $U/L$  depends on the rates of job separation  $s$  and job finding  $f$ . The higher the rate of job separation, the higher the unemployment rate. The higher the rate of job finding, the lower the unemployment rate.

Here's a numerical example. Suppose that 1 percent of the employed lose their jobs each month ( $s = 0.01$ ). This means that the average spell of employment lasts  $1/0.01$ , or 100 months, about 8 years. Suppose further that 20 percent of the unemployed find a job each month ( $f = 0.20$ ), so that the average spell of unemployment last 5 months. Then the steady-state rate of unemployment is

$$\begin{aligned}\frac{U}{L} &= \frac{0.01}{0.01 + 0.20} \\ &= 0.0476.\end{aligned}$$

The rate of unemployment in this example is about 5 percent.

This simple model of the natural rate of unemployment has an important implication for public policy. *Any policy aimed at lowering the natural rate of unemployment must either reduce the rate of job separation or increase the rate of job finding. Similarly, any policy that affects the rate of job separation or job finding also changes the natural rate of unemployment.*

Although this model is useful in relating the unemployment rate to job separation and job finding, it fails to answer a central question: Why is there unemployment in the first place? If a person could always find a job quickly, then the rate of job finding would be very high and the rate of unemployment would be near zero. This model of the unemployment rate assumes that job finding is not instantaneous, but it fails to explain why. In the next two sections, we examine two underlying reasons for unemployment: job search and wage rigidity.

## 7-2 Job Search and Frictional Unemployment

One reason for unemployment is that it takes time to match workers and jobs. The equilibrium model of the aggregate labor market discussed in Chapter 3 assumes that all workers and all jobs are identical and, therefore, that all workers are equally well suited to all jobs. If this were true and the labor market were in equilibrium, then a job loss would not cause unemployment: a laid-off worker would immediately find a new job at the market wage.

In fact, workers have different preferences and abilities, and jobs have different attributes. Furthermore, the flow of information about job candidates and job vacancies is imperfect, and the geographic mobility of workers is not instantaneous. For all these reasons, searching for an appropriate job takes time and effort, and this tends to reduce the rate of job finding. Indeed, because different jobs require different skills and pay different wages, unemployed workers may not accept the first job offer they receive. The unemployment caused by the time it takes workers to search for a job is called **frictional unemployment**.

### Causes of Frictional Unemployment

Some frictional unemployment is inevitable in a changing economy. For many reasons, the types of goods that firms and households demand vary over time. As the demand for goods shifts, so does the demand for the labor that produces those goods. The invention of the personal computer, for example, reduced the demand for typewriters and the demand for labor by typewriter manufacturers. At the same time, it increased the demand for labor in the electronics industry. Similarly, because different regions produce different goods, the demand for labor may be rising in one part of the country and falling in another. An increase in the price of oil may cause the demand for labor to rise in oil-producing states such as Texas, but because expensive oil means expensive gasoline, it makes driving less attractive and may decrease the demand for labor in auto-producing states such as Michigan. Economists call a change in the composition of demand among industries or regions a **sectoral shift**. Because sectoral shifts are always occurring, and because it takes time for workers to change sectors, there is always frictional unemployment.

Sectoral shifts are not the only cause of job separation and frictional unemployment. In addition, workers find themselves unexpectedly out of work when their firms fail, when their job performance is deemed unacceptable, or when their particular skills are no longer needed. Workers also may quit their jobs to change careers or to move to different parts of the country. Regardless of the cause of the job separation, it will take time and effort for the worker to find a new job. As long as the supply and demand for labor among firms is changing, frictional unemployment is unavoidable.

## Public Policy and Frictional Unemployment

Many public policies seek to decrease the natural rate of unemployment by reducing frictional unemployment. Government employment agencies disseminate information about job vacancies to match jobs and workers more efficiently. Publicly funded retraining programs are designed to ease the transition of workers from declining to growing industries. If these programs succeed at increasing the rate of job finding, they decrease the natural rate of unemployment.

Other government programs inadvertently increase the amount of frictional unemployment. One of these is **unemployment insurance**. Under this program, unemployed workers can collect a fraction of their wages for a certain period after losing their jobs. Although the precise terms of the program differ from year to year and from state to state, a typical worker covered by unemployment insurance in the United States receives 50 percent of her former wages for 26 weeks. In many European countries, unemployment-insurance programs are significantly more generous.

By softening the economic hardship of unemployment, unemployment insurance increases the amount of frictional unemployment and raises the natural rate. The unemployed who receive unemployment-insurance benefits are less pressed to search for new employment and are more likely to turn down unattractive job offers. Both of these changes in behavior reduce the rate of job finding. In addition, because workers know that their incomes are partially protected by unemployment insurance, they are less likely to seek jobs with stable employment prospects and are less likely to bargain for guarantees of job security. These behavioral changes raise the rate of job separation.

That unemployment insurance raises the natural rate of unemployment does not necessarily imply that the policy is ill advised. The program has the benefit of reducing workers' uncertainty about their incomes. Moreover, inducing workers to reject unattractive job offers may lead to better matches between workers and jobs. Evaluating the costs and benefits of different systems of unemployment insurance is a difficult task that continues to be a topic of much research.

Economists often propose reforms to the unemployment-insurance system that would reduce the amount of unemployment. One common proposal is to require a firm that lays off a worker to bear the full cost of that worker's unemployment benefits. Such a system is called *100 percent experience rated*, because the rate that each firm pays into the unemployment-insurance system fully reflects the unemployment experience of its own workers. Most current programs are *partially experience rated*. Under this system, when a firm lays off a worker, it is charged for only part of the worker's unemployment benefits; the remainder comes from the program's general revenue. Because a firm pays only a fraction of the cost of the unemployment it causes, it has an incentive to lay off workers when its demand for labor is temporarily low. By reducing that incentive, the proposed reform may reduce the prevalence of temporary layoffs.

## CASE STUDY

## Unemployment Insurance and the Rate of Job Finding

Many studies have examined the effect of unemployment insurance on job search. The most persuasive studies use data on the experiences of unemployed individuals rather than economy-wide rates of unemployment. Individual data often yield sharp results that are open to few alternative explanations.

One study followed the experience of individual workers as they used up their eligibility for unemployment-insurance benefits. It found that when unemployed workers become ineligible for benefits, they are more likely to find jobs. In particular, the probability of a person finding a job more than doubles when his or her benefits run out. One possible explanation is that an absence of benefits increases the search effort of unemployed workers. Another possibility is that workers without benefits are more likely to accept job offers they would otherwise decline because of low wages or poor working conditions.<sup>2</sup>

Additional evidence on how economic incentives affect job search comes from an experiment that the state of Illinois ran in 1985. Randomly selected new claimants for unemployment insurance were each offered a \$500 bonus if they found employment within 11 weeks. The subsequent experience of this group was compared to that of a control group not offered the incentive. The average duration of unemployment for the group offered the \$500 bonus was 17.0 weeks, compared to 18.3 weeks for the control group. Thus, the prospect of earning the bonus reduced the average spell of unemployment by 7 percent, suggesting that more effort was devoted to job search. This experiment shows clearly that the incentives provided by the unemployment-insurance system affect the rate of job finding.<sup>3</sup> ■

## 7-3 Real-Wage Rigidity and Structural Unemployment

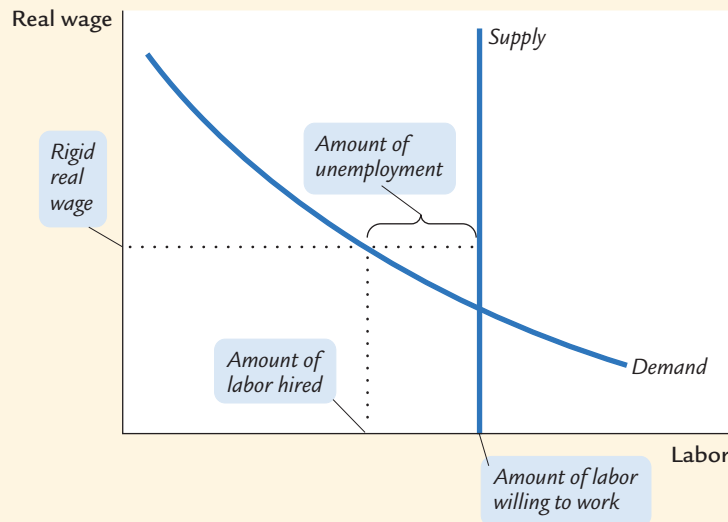
A second reason for unemployment is **wage rigidity**—the failure of wages to adjust to a level at which labor supply equals labor demand. In the equilibrium model of the labor market, as outlined in Chapter 3, the real wage adjusts to equilibrate labor supply and labor demand. Yet wages are not always flexible. Sometimes the real wage is stuck above the market-clearing level.

Figure 7-3 shows why wage rigidity leads to unemployment. When the real wage is above the level that equilibrates supply and demand, the quantity of labor supplied exceeds the quantity demanded. Firms must in some way ration the

<sup>2</sup>Lawrence F. Katz and Bruce D. Meyer, “Unemployment Insurance, Recall Expectations, and Unemployment Outcomes,” *Quarterly Journal of Economics* 105 (November 1990): 973–1002.

<sup>3</sup>Stephen A. Woodbury and Robert G. Spiegelman, “Bonuses to Workers and Employers to Reduce Unemployment: Randomized Trials in Illinois,” *American Economic Review* 77 (September 1987): 513–530.



**FIGURE 7-3**

**Real-Wage Rigidity Leads to Job Rationing** If the real wage is stuck above the equilibrium level, then the supply of labor exceeds the demand. The result is unemployment.

scarce jobs among workers. Real-wage rigidity reduces the rate of job finding and raises the level of unemployment.

The unemployment resulting from wage rigidity and job rationing is sometimes called **structural unemployment**. Workers are unemployed not because they are actively searching for the jobs that best suit their individual skills but because there is a fundamental mismatch between the number of people who want to work and the number of jobs that are available. At the going wage, the quantity of labor supplied exceeds the quantity of labor demanded; many workers are simply waiting for jobs to open up.

To understand wage rigidity and structural unemployment, we must examine why the labor market does not clear. When the real wage exceeds the equilibrium level and the supply of workers exceeds the demand, we might expect firms to lower the wages they pay. Structural unemployment arises because firms fail to reduce wages despite an excess supply of labor. We now turn to three causes of this wage rigidity: minimum-wage laws, the monopoly power of unions, and efficiency wages.

### Minimum-Wage Laws

The government causes wage rigidity when it prevents wages from falling to equilibrium levels. Minimum-wage laws set a legal minimum on the wages that firms pay their employees. Since the passage of the Fair Labor Standards Act of 1938, the U.S. federal government has enforced a minimum wage that has usually been between 30 and 50 percent of the average wage in manufacturing. In addition, many states enact minimum wages that are higher than the federal one: for example, in 2014, when the federal minimum wage was \$7.25 per hour, California had a minimum



wage of \$9.00 per hour. For most workers, the minimum wage is not binding, because they earn well above the legislated minimum. Yet for some workers, especially the unskilled and inexperienced, the minimum wage raises their wage above its equilibrium level and, therefore, reduces the quantity of their labor that firms demand.

Economists believe that the minimum wage has its greatest impact on teenage unemployment. The equilibrium wages of teenagers tend to be low for two reasons. First, because teenagers are among the least skilled and least experienced members of the labor force, they tend to have low marginal productivity. Second, teenagers often take some of their “compensation” in the form of on-the-job training rather than direct pay. An internship is a classic example of training offered in place of wages. For both these reasons, the wage at which the supply of teenage workers equals the demand is low. The minimum wage is therefore more often binding for teenagers than for others in the labor force.

Many economists have studied the impact of the minimum wage on teenage employment. These researchers compare the variation in the minimum wage over time with the variation in the number of teenagers with jobs. These studies find that a 10 percent increase in the minimum wage reduces teenage employment by 1 to 3 percent.<sup>4</sup>

The minimum wage is a perennial source of political debate. Advocates of a higher minimum wage view it as a way to raise the income of the working poor. Certainly, the minimum wage provides only a meager standard of living: in the United States, a single parent with one child working full time at a minimum-wage job would fall below the official poverty level for a family of that size. Although minimum-wage advocates often admit that the policy causes unemployment for some workers, they argue that this cost is worth bearing to raise others out of poverty.

Opponents of a higher minimum wage claim that it is not the best way to help the working poor. They contend not only that the increased labor costs raise unemployment but also that the minimum wage is poorly targeted. Many minimum-wage earners are teenagers from middle-class homes working for discretionary spending money, rather than heads of households working to support their families.

Many economists and policymakers believe that tax credits are a better way to increase the incomes of the working poor. The *earned income tax credit* is an amount that poor working families are allowed to subtract from the taxes they owe. For a family with very low income, the credit exceeds its taxes, and the family receives a payment from the government. Unlike the minimum wage, the earned income tax credit does not raise labor costs to firms and, therefore, does not reduce the quantity of labor that firms demand. It has the disadvantage, however, of reducing the government’s tax revenue.

<sup>4</sup>Charles Brown, “Minimum Wage Laws: Are They Overrated?” *Journal of Economic Perspectives* 2 (Summer 1988): 133–146. Brown presents the mainstream view of the effects of minimum wages, but it should be noted that the magnitude of employment effects is controversial. For research suggesting negligible employment effects, see David Card and Alan Krueger, *Myth and Measurement: The New Economics of the Minimum Wage* (Princeton, NJ: Princeton University Press, 1995); and Lawrence Katz and Alan Krueger, “The Effects of the Minimum Wage on the Fast-Food Industry,” *Industrial and Labor Relations Review* 46 (October 1992): 6–21. For research suggesting the opposite conclusion, see David Neumark and William Wascher, “Employment Effects of Minimum and Subminimum Wages: Panel Data on State Minimum Wage Laws,” *Industrial and Labor Relations Review* 46 (October 1992): 55–81.

## CASE STUDY

**The Characteristics of Minimum-Wage Workers**

Who earns the minimum wage? The question can be answered using the Current Population Survey, the labor-market survey used to calculate the unemployment rate and many other statistics. In 2014, the Bureau of Labor Statistics released a report describing the workers who earned at or below the minimum wage in 2013, when the prevailing minimum wage was \$7.25 per hour. Here is a summary:

- About 76 million American workers are paid hourly, representing 59 percent of all wage and salary workers. Of these workers, 1.5 million reported earning exactly the prevailing minimum wage, and another 1.8 million reported earning less. A reported wage below the minimum is possible because some workers are exempt from the statute (newspaper delivery workers, for example), because enforcement is imperfect, and because some workers round down when reporting their wages on surveys.
- Minimum-wage workers are more likely to be women than men. About 3 percent of men and 5 percent of women reported wages at or below the prevailing federal minimum.
- Minimum-wage workers tend to be young. About half of all hourly-paid workers earning the minimum wage or less were under age 25. Among teenagers, about 20 percent earned the minimum wage or less, compared with about 3 percent of workers age 25 and over.
- Minimum-wage workers tend to be less educated. Among hourly-paid workers age 16 and over, about 10 percent of those without a high school diploma earned the minimum wage or less, compared with 4 percent of those with a high school diploma and 2 percent of those with a college degree.
- Minimum-wage workers are more likely to be working part time. Among part-time workers (those who usually work less than 35 hours per week), 10 percent were paid the minimum wage or less, compared to 2 percent of full-time workers.
- The industry with the highest proportion of workers with reported hourly wages at or below the minimum wage was leisure and hospitality (about 19 percent). Just over one-half of all workers paid at or below the minimum wage were employed in this industry, primarily in food services and drinking places. For many of these workers, tips supplement the hourly wages received.

These facts by themselves do not tell us whether the minimum wage is a good or bad policy, or whether it is too high or too low. But when evaluating any public policy, it is useful to keep in mind those individuals who are affected by it.<sup>5</sup> ■

<sup>5</sup>The figures reported here are from the Web site of the Bureau of Labor Statistics. The link is <http://www.bls.gov/cps/minwage2013.pdf>.

Unions and Collective Bargaining

A second cause of wage rigidity is the monopoly power of unions. Table 7-1 shows the importance of unions in several major countries. In the United States, only 13 percent of workers have their wages set through collective bargaining. In most European countries, unions play a much larger role.

The wages of unionized workers are determined not by the equilibrium of supply and demand but by bargaining between union leaders and firm management. Often, the final agreement raises the wage above the equilibrium level and allows the firm to decide how many workers to employ. The result is a reduction in the number of workers hired, a lower rate of job finding, and an increase in structural unemployment.

Unions can also influence the wages paid by firms whose workforces are not unionized because the threat of unionization can keep wages above the equilibrium level. Most firms dislike unions. Unions not only raise wages but also increase the bargaining power of labor on many other issues, such as hours of employment and working conditions. A firm may choose to pay its workers high wages to keep them happy and discourage them from forming a union.

The unemployment caused by unions and by the threat of unionization is an instance of conflict between different groups of workers—**insiders** and **outsiders**. Those workers already employed by a firm, the insiders, typically try to keep their firm’s wages high. The unemployed, the outsiders, bear part of the cost

TABLE 7-1  
Percent of Workers Covered by Collective Bargaining

South Korea	10 %
United States	13
Turkey	13
Japan	16
Canada	29
Poland	29
United Kingdom	31
Australia	45
Switzerland	49
Israel	56
Germany	61
Greece	65
Spain	73
Netherlands	84
Italy	85
Sweden	91
France	92
Belgium	96

Data from: *Economic Policy Reforms 2014: Going for Growth*, OECD, 2014.

of higher wages because at a lower wage they might be hired. These two groups inevitably have conflicting interests. The effect of any bargaining process on wages and employment depends crucially on the relative influence of each group.

The conflict between insiders and outsiders is resolved differently in different countries. In some countries, such as the United States, wage bargaining takes place at the level of the firm or plant. In other countries, such as Sweden, wage bargaining takes place at the national level—with the government often playing a key role. Despite a highly unionized labor force, Sweden has not experienced extraordinarily high unemployment throughout its history. One possible explanation is that the centralization of wage bargaining and the role of the government in the bargaining process give more influence to the outsiders, which keeps wages closer to the equilibrium level.

## Efficiency Wages

**Efficiency-wage** theories propose a third cause of wage rigidity in addition to minimum-wage laws and unionization. These theories hold that high wages make workers more productive. The influence of wages on worker efficiency may explain the failure of firms to cut wages despite an excess supply of labor. Even though a wage reduction would lower a firm's wage bill, it would also—if these theories are correct—lower worker productivity and the firm's profits.

Economists have proposed various theories to explain how wages affect worker productivity. One efficiency-wage theory, which is applied mostly to poorer countries, holds that wages influence nutrition. Better-paid workers can afford a more nutritious diet, and healthier workers are more productive. A firm may decide to pay a wage above the equilibrium level to maintain a healthy workforce. Obviously, this consideration is not important for employers in wealthier countries, such as the United States and most of Europe, because the equilibrium wage is well above the level necessary to maintain good health.

A second efficiency-wage theory, which is more relevant for developed countries, holds that high wages reduce labor turnover. Workers quit jobs for many reasons—to accept better positions at other firms, to change careers, or to move to other parts of the country. The more a firm pays its workers, the greater is their incentive to stay with the firm. By paying a high wage, a firm reduces the frequency at which its workers quit, thereby decreasing the time and money spent hiring and training new workers.

A third efficiency-wage theory holds that the average quality of a firm's workforce depends on the wage it pays its employees. If a firm reduces its wage, the best employees may take jobs elsewhere, leaving the firm with inferior employees who have fewer alternative opportunities. Economists recognize this unfavorable sorting as an example of *adverse selection*—the tendency of people with more information (in this case, the workers, who know their own outside opportunities) to self-select in a way that disadvantages people with less information (the firm). By paying a wage above the equilibrium level, the firm may reduce adverse selection, improve the average quality of its workforce, and thereby increase productivity.

A fourth efficiency-wage theory holds that a high wage improves worker effort. This theory posits that firms cannot perfectly monitor their employees' work effort

and that employees must themselves decide how hard to work. Workers can choose to work hard, or they can choose to shirk and risk getting caught and fired. Economists recognize this possibility as an example of *moral hazard*—the tendency of people to behave inappropriately when their behavior is imperfectly monitored. The firm can reduce the problem of moral hazard by paying a high wage. The higher the wage, the greater the cost to the worker of getting fired. By paying a higher wage, a firm induces more of its employees not to shirk and thus increases their productivity.

Although these four efficiency-wage theories differ in detail, they share a common theme: because a firm operates more efficiently if it pays its workers a high wage, the firm may find it profitable to keep wages above the level that balances supply and demand. The result of this higher-than-equilibrium wage is a lower rate of job finding and greater unemployment.<sup>6</sup>

### CASE STUDY

#### Henry Ford's \$5 Workday

In 1914 the Ford Motor Company started paying its workers \$5 per day. The prevailing wage at the time was between \$2 and \$3 per day, so Ford's wage was well above the equilibrium level. Not surprisingly, long lines of job seekers waited outside the Ford plant gates hoping for a chance to earn this high wage.

What was Ford's motive? Henry Ford later wrote, "We wanted to pay these wages so that the business would be on a lasting foundation. We were building for the future. A low wage business is always insecure. . . . The payment of five dollars a day for an eight hour day was one of the finest cost-cutting moves we ever made."

From the standpoint of traditional economic theory, Ford's explanation seems peculiar. He was suggesting that *high* wages imply *low* costs. But perhaps Ford had discovered efficiency-wage theory. Perhaps he was using the high wage to increase worker productivity.

Evidence suggests that paying such a high wage did benefit the company. According to an engineering report written at the time, "The Ford high wage does away with all the inertia and living force resistance. . . . The workingmen are absolutely docile, and it is safe to say that since the last day of 1913, every single day has seen major reductions in Ford shops' labor costs." Absenteeism fell by 75 percent, suggesting a large increase in worker effort. Alan Nevins, a historian who studied the early Ford Motor Company, wrote, "Ford and his associates freely declared on many occasions that the high wage policy had turned out to be good business. By this they meant that it had improved the discipline of the workers, given them a more loyal interest in the institution, and raised their personal efficiency."<sup>7</sup> ■

<sup>6</sup>For more extended discussions of efficiency wages, see Janet Yellen, "Efficiency Wage Models of Unemployment," *American Economic Review Papers and Proceedings* (May 1984): 200–205; and Lawrence Katz, "Efficiency Wages: A Partial Evaluation," *NBER Macroeconomics Annual* (1986): 235–276.

<sup>7</sup>Jeremy I. Bulow and Lawrence H. Summers, "A Theory of Dual Labor Markets with Application to Industrial Policy, Discrimination, and Keynesian Unemployment," *Journal of Labor Economics* 4 (July 1986): 376–414; Daniel M. G. Raff and Lawrence H. Summers, "Did Henry Ford Pay Efficiency Wages?" *Journal of Labor Economics* 5 (October 1987, Part 2): S57–S86.

## 7-4 Labor-Market Experience: The United States

So far we have developed the theory behind the natural rate of unemployment. We began by showing that the economy's steady-state unemployment rate depends on the rates of job separation and job finding. Then we discussed two reasons that job finding is not instantaneous: the process of job search (which leads to frictional unemployment) and wage rigidity (which leads to structural unemployment). Wage rigidity, in turn, arises from minimum-wage laws, unionization, and efficiency wages.

With these theories as background, we now examine some additional facts about unemployment, focusing at first on the case of American labor markets. These facts will help us to evaluate our theories and assess public policies aimed at reducing unemployment.

### The Duration of Unemployment

When a person becomes unemployed, is the spell of unemployment likely to be short or long? The answer to this question is important because it indicates the reasons for the unemployment and what policy response is appropriate. On the one hand, if most unemployment is short-term, one might argue that it is frictional and perhaps unavoidable. Unemployed workers may need some time to search for the job that is best suited to their skills and tastes. On the other hand, long-term unemployment cannot easily be attributed to the time it takes to match jobs and workers: we would not expect this matching process to take many months. Long-term unemployment is more likely to be structural unemployment, representing a mismatch between the number of jobs available and the number of people who want to work. Thus, data on the duration of unemployment can affect our view about the reasons for unemployment.

The answer to our question turns out to be subtle. The data show that many spells of unemployment are short but that most weeks of unemployment are attributable to the long-term unemployed. For example, during the period from 1990 to 2006, 38 percent of unemployed people were unemployed for less than 4 weeks, while only 31 percent were unemployed for more than 15 weeks. However, 71 percent of the total amount of time spent unemployed was experienced by those who were unemployed for more than 15 weeks, while only 7 percent of the time spent unemployed was experienced by people who were unemployed for less than 4 weeks.

To see how these facts can all be true, consider an extreme but simple example. Suppose that 10 people are unemployed for part of a given year. Of these 10 people, 8 are unemployed for 1 month and 2 are unemployed for 12 months, totaling 32 months of unemployment. In this example, most spells of unemployment are short: 8 of the 10 unemployment spells, or 80 percent, end in 1 month. Yet most months of unemployment are attributable to the long-term unemployed: 24 of the 32 months of unemployment, or 75 percent, are experienced by the 2 workers who are each unemployed for 12 months. Depending on whether we look at spells of unemployment or months of unemployment, most unemployment can appear to be either short-term or long-term.

This evidence on the duration of unemployment has an important implication for public policy. If the goal is to substantially lower the natural rate of unemployment, policies must aim at the long-term unemployed, because these individuals account for a large amount of unemployment. Yet policies must be carefully targeted, because the long-term unemployed constitute a small minority of those who become unemployed. Most people who become unemployed find work within a short time.

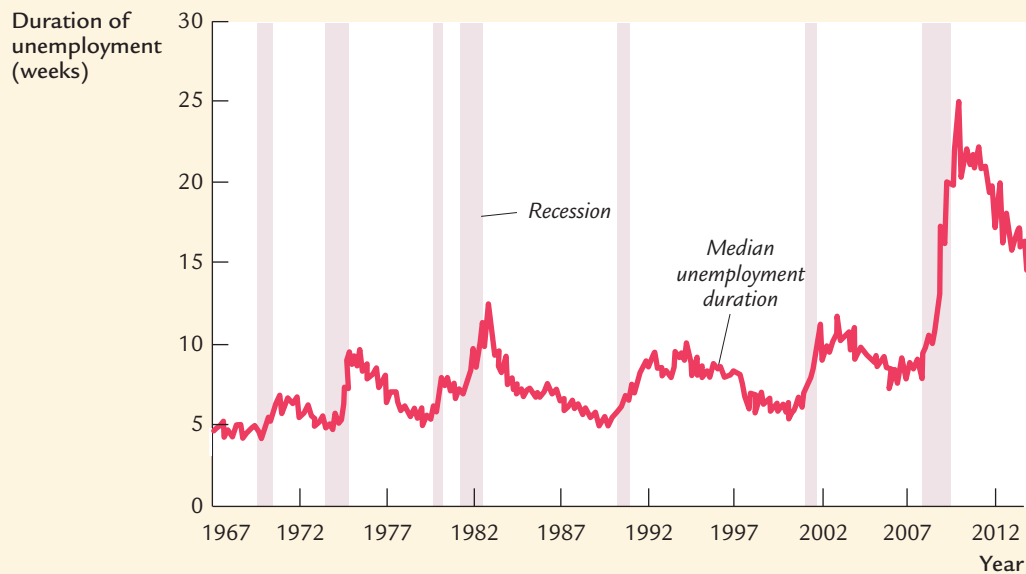
### CASE STUDY

## The Increase in U.S. Long-Term Unemployment and the Debate Over Unemployment Insurance

In 2008 and 2009, as the U.S. economy experienced a deep recession, the labor market demonstrated a new and striking phenomenon: a large upward spike in the duration of unemployment. Figure 7-4 shows the median duration of unemployment for jobless workers from 1967 to 2014. Recessions are indicated by shaded areas. The figure shows that the duration of unemployment typically rises during recessions. The huge increase during the recession of 2008–2009, however, is without precedent in modern history.

What explains this phenomenon? Economists fall into two camps.

**FIGURE 7-4**



**The Median Duration of Unemployment** The median duration of unemployment typically rises during recessions, shown as the shaded areas here, but its spike upward during the recession of 2008–2009 was unprecedented.

Data from: Bureau of Labor Statistics.



Some economists believe that the increase in long-term unemployment is a result of government policies. In particular, in February 2009, when the depth of the recession was apparent, Congress extended the eligibility for unemployment insurance from the normal 26 weeks to 99 weeks, and it did not allow this program of extended benefits to expire until January 2014. Extending unemployment-insurance benefits is typical during recessions, because jobs are harder to find, but the extension to nearly two years was extraordinary.

Harvard economist Robert Barro wrote an article in the August 30, 2010, issue of the *Wall Street Journal* titled “The Folly of Subsidizing Unemployment.” According to Barro, “the dramatic expansion of unemployment insurance eligibility to 99 weeks is almost surely the culprit” responsible for the rise in long-term unemployment. He writes:

Generous unemployment insurance programs have been found to raise unemployment in many Western European countries in which unemployment rates have been far higher than the current U.S. rate. In Europe, the influence has worked particularly through increases in long-term unemployment.

Barro concludes that the “reckless expansion of unemployment-insurance coverage to 99 weeks was unwise economically and politically.”

Other economists, however, are skeptical that these government policies are to blame. In their opinion, the extraordinary increase in eligibility for unemployment insurance was a reasonable and compassionate response to a historically deep economic downturn and weak labor market.

Here is Princeton economist Paul Krugman, writing in a July 4, 2010, *New York Times* article titled “Punishing the Jobless”:

Do unemployment benefits reduce the incentive to seek work? Yes: workers receiving unemployment benefits aren’t quite as desperate as workers without benefits, and are likely to be slightly more choosy about accepting new jobs. The operative word here is “slightly”: recent economic research suggests that the effect of unemployment benefits on worker behavior is much weaker than was previously believed. Still, it’s a real effect when the economy is doing well.

But it’s an effect that is completely irrelevant to our current situation. When the economy is booming, and lack of sufficient willing workers is limiting growth, generous unemployment benefits may keep employment lower than it would have been otherwise. But as you may have noticed, right now the economy isn’t booming—there are five unemployed workers for every job opening. Cutting off benefits to the unemployed will make them even more desperate for work—but they can’t take jobs that aren’t there.

Wait: there’s more. One main reason there aren’t enough jobs right now is weak consumer demand. Helping the unemployed, by putting money in the pockets of people who badly need it, helps support consumer spending.<sup>8</sup>

Barro and Krugman are both prominent economists, but they have diametrically opposed views about this fundamental policy debate. The cause of the spike in U.S. long-term unemployment remains an unsettled debate. ■

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## Variation in the Unemployment Rate Across Demographic Groups

The rate of unemployment varies substantially across different groups within the population. Table 7-2 presents the U.S. unemployment rates for different demographic groups in 2014, when the overall unemployment rate was 6.2 percent.

This table shows that younger workers have much higher unemployment rates than older ones. To explain this difference, recall our model of the natural rate of unemployment. The model isolates two possible causes for a high rate of unemployment: a low rate of job finding and a high rate of job separation. When economists study data on the transition of individuals between employment and unemployment, they find that those groups with high unemployment tend to have high rates of job separation. They find less variation across groups in the rate of job finding. For example, an employed white male is four times more likely to become unemployed if he is a teenager than if he is middle-aged; once he is unemployed, his rate of job finding is not closely related to his age.

These findings help explain the higher unemployment rates for younger workers. Younger workers have only recently entered the labor market, and they are often uncertain about their career plans. It may be best for them to try different types of jobs before making a long-term commitment to a specific occupation. If they do so, we should expect a higher rate of job separation and a higher rate of frictional unemployment for this group.

Another fact that stands out from Table 7-2 is that unemployment rates are much higher for blacks than for whites. This phenomenon is not well understood. Data on transitions between employment and unemployment show that the higher unemployment rates for blacks, especially for black teenagers, arise because of both higher rates of job separation and lower rates of job finding. Possible reasons for the lower rates of job finding include less access to informal job-finding networks and discrimination by employers.

## Transitions Into and Out of the Labor Force

So far we have ignored an important aspect of labor-market dynamics: the movement of individuals into and out of the labor force. Our model of the natural rate of unemployment assumes that the labor force is fixed. In this case, the

**TABLE 7-2**

**Unemployment Rate by Demographic Group (2014)**

Age	White Men	White Women	Black Men	Black Women
16–19	19.2	15.5	36.5	29.7
25–54	4.4	4.6	10.1	9.1

*Data from:* Bureau of Labor Statistics.

sole reason for unemployment is job separation, and the sole reason for leaving unemployment is job finding.

In fact, movements into and out of the labor force are important. About one-third of the unemployed have only recently entered the labor force. Some of these entrants are young workers still looking for their first jobs; others have worked before but had temporarily left the labor force. In addition, not all unemployment ends with job finding: almost half of all spells of unemployment end in the unemployed person’s withdrawal from the labor market.

Individuals entering and leaving the labor force make unemployment statistics more difficult to interpret. On the one hand, some individuals calling themselves unemployed may not be seriously looking for jobs and perhaps should best be viewed as out of the labor force. Their “unemployment” may not represent a social problem. On the other hand, some individuals may want jobs but, after unsuccessful searches, have given up looking. These **discouraged workers** are counted as being out of the labor force and do not show up in unemployment statistics. Even though their joblessness is unmeasured, it may nonetheless be a social problem.

Because of these and many other issues that complicate the interpretation of the unemployment data, the Bureau of Labor Statistics calculates several measures of labor underutilization. Table 7-3 gives the definitions and their values as of October 2014. The measures range from 2.8 to 11.5 percent, depending on the characteristics one uses to classify a worker as not fully employed.

**TABLE 7-3**  
**Alternative Measures of Labor Underutilization**

Variable	Description	Rate
U-1	Persons unemployed 15 weeks or longer, as a percent of the civilian labor force (includes only very long-term unemployed)	2.8%
U-2	Job losers and persons who have completed temporary jobs, as a percent of the civilian labor force (excludes job leavers)	2.8
U-3	Total unemployed, as a percent of the civilian labor force (official unemployment rate)	5.8
U-4	Total unemployed, plus discouraged workers, as a percent of the civilian labor force plus discouraged workers	6.2
U-5	Total unemployed plus all marginally attached workers, as a percent of the civilian labor force plus all marginally attached workers	7.1
U-6	Total unemployed, plus all marginally attached workers, plus total employed part time for economic reasons, as a percent of the civilian labor force plus all marginally attached workers	11.5

*Note: Marginally attached workers* are persons who currently are neither working nor looking for work but indicate that they want and are available for a job and have looked for work sometime in the recent past. *Discouraged workers*, a subset of the marginally attached, have given a job-market-related reason for not currently looking for a job. *Persons employed part time for economic reasons* are those who want and are available for full-time work but have had to settle for a part-time schedule.

*Data from:* U.S. Department of Labor. Data are for October 2014.

## CASE STUDY

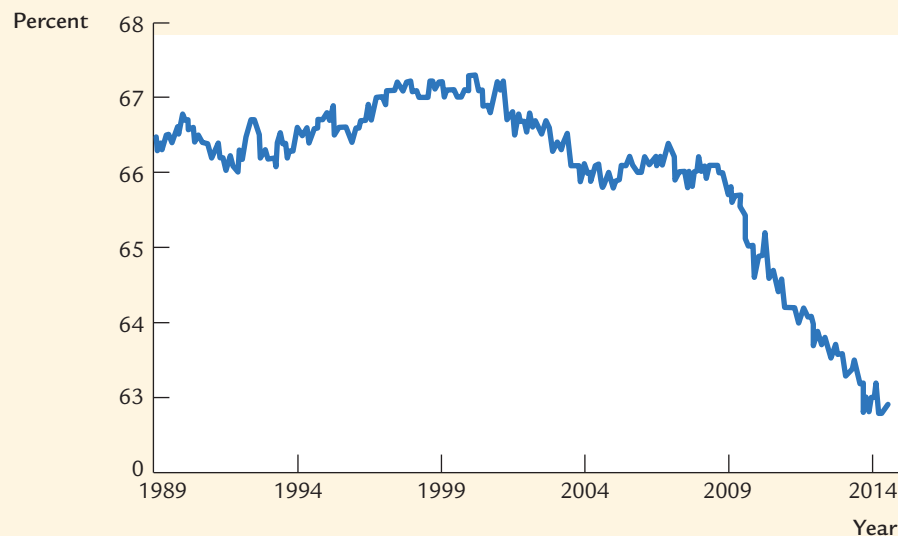
**The Decline in Labor-Force Participation: 2007 to 2014**

One of the more striking recent developments in the U.S. labor market is the decline in labor-force participation. Figure 7-5 illustrates the phenomenon. From 1990 to 2007, the labor-force participation rate fluctuated in a narrow range between about 66 and 67 percent. But then it started a gradual but significant decline. From the fourth quarter of 2007 to the first quarter of 2014, the labor-force participation rate fell from 66.1 percent to 63.0 percent. As a result of this change, about 7 million fewer Americans were working or looking for work in 2014 than otherwise would have been the case.

What explains the decline of 3.1 percentage points in the labor-force participation rate? To answer this question, a natural place to start is to study those individuals not in the labor force to see why they are not working or looking for work. Economist Shigeru Fujita of the Federal Reserve Bank of Philadelphia has done exactly that using the data in the Current Population Survey.

His findings, summarized in Table 7-4, allocate the 3.1 percentage points among five categories:

- An increase in retired workers accounts for 1.4 percentage points.
- An increase in disabled workers accounts for 0.8 percentage points.
- An increase in discouraged workers accounts for 0.4 percentage points.

**FIGURE 7-5**

**The Labor-Force Participation Rate** The labor-force participation rate declined significantly from 2007 to 2014.

*Data from:* Bureau of Labor Statistics.

- An increase in those not wanting a job because they are in school accounts for 0.5 percentage points.
- The “other” category—those outside the labor force who are not retired, disabled, discouraged, or in school, such as full-time parents—accounts for none of the change. In fact, this last category went slightly in the other direction.

With this decomposition in hand, we can discuss some of the forces at work.

According to the numbers in Table 7-4, retirement explains the largest share of the increase in nonparticipation, accounting for almost half the change. The increase in the number of retired workers is largely due to the aging of the large baby-boom generation. The baby boom started in 1946, just after World War II as soldiers returned home and started families, and continued until 1964. The first of the baby boomers turned 62—the earliest age at which a person can start collecting Social Security retirement benefits—in 2008. So far, we have seen just the tip of a sizeable iceberg: as more baby boomers reach retirement age in the years to come, the labor-force participation rate will probably continue to decline.

Another force at work is that during much of the period from 2007 to 2014, the economy was weak. Because of a financial crisis and deep recession (a topic discussed in detail in Chapters 12 and 20), unemployment, especially long-term unemployment, was high. The lack of good job opportunities during this time certainly increased the number of discouraged workers. But it likely influenced people in many other ways as well. When the options offered by the labor market are poor, the alternatives to work look better by comparison. In particular, the weak labor market may have induced older workers to retire earlier, workers with infirmities to apply for disability benefits more quickly, and students to stay in school longer. All of these effects reduced labor-force participation.

To be sure, these developments are not entirely adverse. For the elderly, retirement is often a welcome change in lifestyle after a lifetime of toil. For the young, staying in school is often a sensible investment in human capital. Yet the decline in labor-force participation does have a cost. With a smaller labor force, the economy naturally produces a smaller output of goods and services, which in turn means a lower level of real GDP. ■

**TABLE 7-4**  
**Decomposing the Change in Labor-Force Participation**

Quarter	Nonparticipation	----- By Reason for Nonparticipation -----				
		Retired	Disabled	Discouraged	In school	Other
2007: Q4	33.9 %	15.5 %	4.9 %	1.9 %	4.6 %	7.1 %
2014: Q1	37.0	16.9	5.7	2.3	5.1	7.0
Change	+3.1	+1.4	+0.8	+0.4	+0.5	−0.1

*Data from: Shigeru Fujita, “On the Causes of Declines in the Labor Force Participation Rate,” Federal Reserve Bank of Philadelphia, 2014. Parts may not add to total because of rounding.*

## 7-5 Labor-Market Experience: Europe

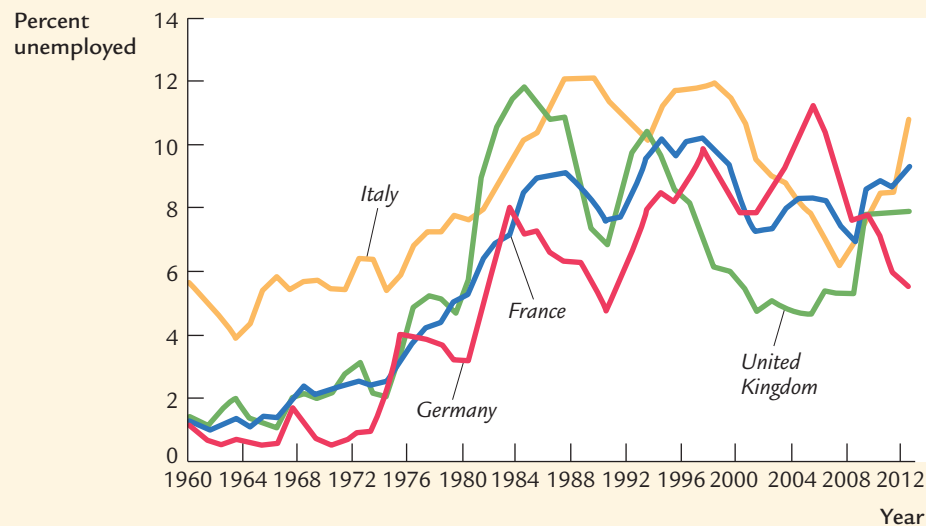
Although our discussion has focused largely on the United States, many fascinating and sometimes puzzling phenomena become apparent when economists compare the experiences of Americans in the labor market with those of Europeans.

### The Rise in European Unemployment

Figure 7-6 shows the rate of unemployment from 1960 to 2012 in the four largest European countries—France, Germany, Italy, and the United Kingdom. As you can see, the rate of unemployment in these countries has risen substantially. For France, for example, unemployment averaged below 2 percent in the 1960s and above 8 percent in recent years.

What is the cause of rising European unemployment? No one knows for sure, but there is a leading theory. Many economists believe that the problem can be traced to the interaction between a long-standing policy and a more recent shock. The long-standing policy is generous benefits for unemployed workers. The recent shock is a technologically driven fall in the demand for unskilled workers relative to skilled workers.

**FIGURE 7-6**



**Unemployment in Europe** This figure shows the unemployment rate in the four largest nations in Europe. The figure shows that the European unemployment rate has risen substantially over time, especially in France and Germany.

Data from: OECD.

There is no question that most European countries have generous programs for those without jobs. These programs go by various names: social insurance, the welfare state, or simply “the dole.” Many countries allow the unemployed to collect benefits for years, rather than for only a short period of time as in the United States. In some sense, those living on the dole are really out of the labor force: given the employment opportunities available, taking a job is less attractive than remaining without work. Yet these people are often counted as unemployed in government statistics.

There is also no question that the demand for unskilled workers has fallen relative to the demand for skilled workers. This change in demand is probably due to changes in technology: computers, for example, increase the demand for workers who can use them and reduce the demand for those who cannot. In the United States, this change in demand has been reflected in wages rather than unemployment: over the past three decades, the wages of unskilled workers have fallen substantially relative to the wages of skilled workers. In Europe, however, the welfare state provides unskilled workers with an alternative to working for low wages. As the wages of unskilled workers fall, more workers view the dole as their best available option. The result is higher unemployment.

This diagnosis of high European unemployment does not suggest an easy remedy. Reducing the magnitude of government benefits for the unemployed would encourage workers to get off the dole and accept low-wage jobs. But it would also exacerbate economic inequality—the very problem that welfare-state policies were designed to address.<sup>9</sup>

## Unemployment Variation Within Europe

Europe is not a single labor market but is, instead, a collection of national labor markets, separated not only by national borders but also by differences in culture and language. Because these countries differ in their labor-market policies and institutions, variation within Europe provides a useful perspective on the causes of unemployment. Many empirical studies have, therefore, focused on these international differences.

The first noteworthy fact is that the unemployment rate varies substantially from country to country. For example, in March 2014, when the unemployment rate was 6.7 percent in the United States, it was 5.1 percent in Germany and 25.3 percent in Spain. Although in recent years average unemployment has been higher in Europe than in the United States, many Europeans live in nations with unemployment rates lower than the U.S. rate.

A second notable fact is that much of the variation in unemployment rates is attributable to the long-term unemployed. The unemployment rate can be separated into two pieces—the percentage of the labor force that has been unemployed for

<sup>9</sup>For more discussion of these issues, see Paul Krugman, “Past and Prospective Causes of High Unemployment,” in *Reducing Unemployment: Current Issues and Policy Options*, Federal Reserve Bank of Kansas City, August 1994.



less than a year and the percentage of the labor force that has been unemployed for more than a year. The long-term unemployment rate exhibits more variability from country to country than does the short-term unemployment rate.

National unemployment rates are correlated with a variety of labor-market policies. Unemployment rates are higher in nations with more generous unemployment insurance, as measured by the replacement rate—the percentage of previous wages that is replaced when a worker loses a job. In addition, nations tend to have higher unemployment, especially higher long-term unemployment, if benefits can be collected for longer periods of time.

Although government spending on unemployment insurance seems to raise unemployment, spending on “active” labor-market policies appears to decrease it. These active labor-market policies include job training, assistance with job search, and subsidized employment. Spain, for instance, has historically had a high rate of unemployment, a fact that can be explained by the combination of generous payments to the unemployed with minimal assistance at helping them find new jobs.

The role of unions also varies from country to country, as we saw in Table 7-1. This fact also helps explain differences in labor-market outcomes. National unemployment rates are positively correlated with the percentage of the labor force whose wages are set by collective bargaining with unions. The adverse impact of unions on unemployment is smaller, however, in nations where there is substantial coordination among employers in bargaining with unions, perhaps because coordination may moderate the upward pressure on wages.

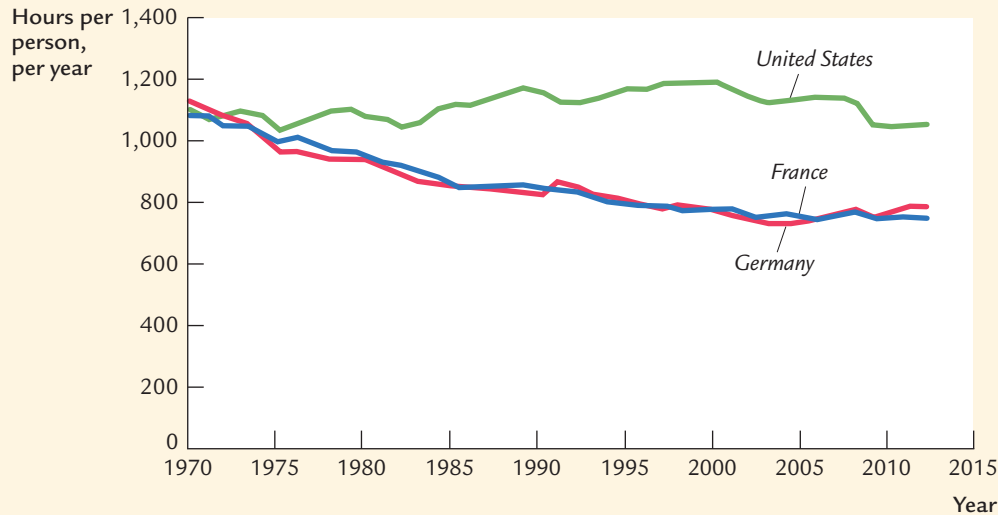
A word of warning: correlation does not imply causation, so empirical results such as these should be interpreted with caution. But they do suggest that a nation’s unemployment rate, rather than being immutable, is instead a function of the choices a nation makes.<sup>10</sup>

## The Rise of European Leisure

Higher unemployment rates in Europe are part of the larger phenomenon that Europeans typically work fewer hours than do their American counterparts. Figure 7-7 presents some data on how many hours a typical person works in the United States, France, and Germany. In the early 1970s, the number of hours worked was about the same in each of these countries. But since then, the number of hours has stayed level in the United States, while it has declined substantially in Europe. Today, the typical American works many more hours than the typical resident of these two western European countries.

The difference in hours worked reflects two facts. First, the average employed person in the United States works more hours per year than the average employed person in Europe. Europeans typically enjoy shorter workweeks and more frequent holidays. Second, more potential workers are employed in the United States.

<sup>10</sup>Stephen Nickell, “Unemployment and Labor Market Rigidities: Europe Versus North America,” *Journal of Economic Perspectives* 11 (September 1997): 55–74.

**FIGURE 7-7**

**Annual Hours Worked per Person** Over time, many Europeans have substantially reduced the number of hours they work, while typical Americans have not.

*Data from:* OECD Employment Database and Bureau of Labor Statistics. Calculated as the average annual hours actually worked per employed person multiplied by the employment rate.

That is, the employment-to-population ratio is higher in the United States than it is in Europe. Higher unemployment is one reason for the lower employment-to-population ratio in Europe. Another reason is earlier retirement in Europe and thus lower labor-force participation among older workers.

What is the underlying cause of these differences in work patterns? Economists have proposed several hypotheses.

Edward Prescott, the 2004 winner of the Nobel Prize in economics, has concluded that “virtually all of the large differences between U.S. labor supply and those of Germany and France are due to differences in tax systems.” This hypothesis is consistent with two facts: (1) Europeans face higher tax rates than Americans, and (2) European tax rates have risen significantly over the past several decades. Some economists take these facts as powerful evidence for the impact of taxes on work effort. Yet others are skeptical, arguing that to explain the difference in hours worked by tax rates alone requires an implausibly large elasticity of labor supply.

A related hypothesis is that the difference in observed work effort may be attributable to the underground economy. When tax rates are high, people have a greater incentive to work “off the books” to evade taxes. For obvious reasons, data on the underground economy are hard to come by. But economists who study the subject believe the underground economy is larger in Europe than it is in the United States. This fact suggests that the difference in actual hours worked,

including work in the underground economy, may be smaller than the difference in measured hours worked.

Another hypothesis stresses the role of unions. As we have seen, collective bargaining is more important in European than in U.S. labor markets. Unions often push for shorter workweeks in contract negotiations, and they lobby the government for a variety of labor-market regulations, such as official holidays. Economists Alberto Alesina, Edward Glaeser, and Bruce Sacerdote conclude that “mandated holidays can explain 80 percent of the difference in weeks worked between the U.S. and Europe and 30 percent of the difference in total labor supply between the two regions.” They suggest that Prescott may overstate the role of taxes because, looking across countries, tax rates and unionization rates are positively correlated; as a result, the effects of high taxes and the effects of widespread unionization are hard to disentangle.

A final hypothesis emphasizes the possibility of different preferences. As technological advance and economic growth have made all advanced countries richer, people around the world must decide whether to take the greater prosperity in the form of increased consumption of goods and services or increased leisure. According to economist Olivier Blanchard, “the main difference [between the continents] is that Europe has used some of the increase in productivity to increase leisure rather than income, while the U.S. has done the opposite.” Blanchard believes that Europeans simply have more taste for leisure than do Americans. (As a French economist working in the United States, he may have special insight into this phenomenon.) If Blanchard is right, this raises the even harder question of why tastes vary by geography.

Economists continue to debate the merits of these alternative hypotheses. In the end, there may be some truth to all of them.<sup>11</sup>

## 7-6 Conclusion

Unemployment represents wasted resources. Unemployed workers have the potential to contribute to national income but are not doing so. Those searching for jobs to suit their skills are happy when the search is over, and those waiting for jobs in firms that pay above-equilibrium wages are happy when positions open up.

Unfortunately, neither frictional unemployment nor structural unemployment can be easily reduced. The government cannot make job search instantaneous, and it cannot easily bring wages closer to equilibrium levels. Zero unemployment is not a plausible goal for free-market economies.

<sup>11</sup>To read more about this topic, see Edward C. Prescott “Why Do Americans Work So Much More Than Europeans?” *Federal Reserve Bank of Minneapolis Quarterly Review* 28, no. 1 (July 2004): 2–13; Alberto Alesina, Edward Glaeser, and Bruce Sacerdote, “Work and Leisure in the U.S. and Europe: Why So Different?” *NBER Macroeconomics Annual* 2005; and Olivier Blanchard, “The Economic Future of Europe,” *Journal of Economic Perspectives* 18, no. 4 (Fall 2004): 3–26.

Yet public policy is not powerless in the fight to reduce unemployment. Job-training programs, the unemployment-insurance system, the minimum wage, and the laws governing collective bargaining are often topics of political debate. The policies we choose are likely to have important effects on the economy's natural rate of unemployment.

Summary

- 1. The natural rate of unemployment is the steady-state rate of unemployment. It depends on the rate of job separation and the rate of job finding.
- 2. Because it takes time for workers to search for the jobs that best suit their individual skills and tastes, some frictional unemployment is inevitable. Various government policies, such as unemployment insurance, alter the amount of frictional unemployment.
- 3. Structural unemployment results when the real wage remains above the level that equilibrates labor supply and labor demand. Minimum-wage legislation is one cause of wage rigidity. Unions and the threat of unionization are another. Finally, efficiency-wage theories suggest that, for various reasons, firms may find it profitable to keep wages high despite an excess supply of labor.
- 4. Whether we conclude that most unemployment is short-term or long-term depends on how we look at the data. Most spells of unemployment are short. Yet most weeks of unemployment are attributable to the small number of long-term unemployed.
- 5. The unemployment rates among demographic groups differ substantially. In particular, the unemployment rates for younger workers are much higher than for older workers. This results from a difference in the rate of job separation rather than from a difference in the rate of job finding.
- 6. Individuals who have recently entered the labor force, including both new entrants and reentrants, make up about one-third of the unemployed. Transitions into and out of the labor force make unemployment statistics more difficult to interpret.
- 7. American and European labor markets exhibit some significant differences. In recent years, Europe has experienced significantly more unemployment than the United States. In addition, because of higher unemployment, shorter workweeks, more holidays, and earlier retirement, Europeans work fewer hours than Americans.



KEY CONCEPTS


Natural rate of unemployment	Unemployment insurance	Insiders versus outsiders
Frictional unemployment	Wage rigidity	Efficiency wages
Sectoral shift	Structural unemployment	Discouraged workers


## QUESTIONS FOR REVIEW

1. What determines the natural rate of unemployment?
2. Describe the difference between frictional unemployment and structural unemployment.
3. Give three explanations of why the real wage may remain above the level that equilibrates labor supply and labor demand.
4. Is most unemployment long-term or short-term? Explain your answer.
5. Do Europeans work more or fewer hours than Americans? List three hypotheses that have been suggested to explain the difference.

## PROBLEMS AND APPLICATIONS

1. Answer the following questions about your own experience in the labor force.
  - a. When you or one of your friends is looking for a part-time job, how many weeks does it typically take? After you find a job, how many weeks does it typically last?
  - b. From your estimates, calculate (in a rate per week) your rate of job finding  $f$  and your rate of job separation  $s$ . (*Hint:* If  $f$  is the rate of job finding, then the average spell of unemployment is  $1/f$ .)
  - c. What is the natural rate of unemployment for the population you represent?
2.  **LaunchPad** • The residents of a certain dormitory have collected the following data: people who live in the dorm can be classified as either involved in a relationship or uninvolved. Among involved people, 10 percent experience a breakup of their relationship every month. Among uninvolved people, 5 percent enter into a relationship every month. What is the steady-state fraction of residents who are uninvolved?
3. In this chapter we saw that the steady-state rate of unemployment is  $U/L = s/(s + f)$ . Suppose that the unemployment rate does not begin at this level. Show that unemployment will evolve over time and reach this steady state. (*Hint:* Express the change in the number of unemployed as a function of  $s$ ,  $f$ , and  $U$ . Then show that if unemployment is above the natural rate, unemployment falls, and if unemployment is below the natural rate, unemployment rises.)
4. Suppose that Congress passes legislation making it more difficult for firms to fire workers. (An example is a law requiring severance pay for fired workers.) If this legislation reduces the rate of job separation without affecting the rate of job finding, how would the natural rate of unemployment change? Do you think it is plausible that the legislation would not affect the rate of job finding? Why or why not?
5.  **LaunchPad** • Consider an economy with the following Cobb–Douglas production function:
 
$$Y = 5K^{1/3}L^{2/3}.$$
  - a. Derive the equation describing labor demand in this economy as a function of the real wage and the capital stock. (*Hint:* Review Chapter 3.)
  - b. The economy has 27,000 units of capital and a labor force of 1,000 workers. Assuming that factor prices adjust to equilibrate supply and demand, calculate the real wage, total output, and the total amount earned by workers.
  - c. Now suppose that Congress, concerned about the welfare of the working class, passes a law setting a minimum wage that is 10 percent above the equilibrium wage you derived in part (b). Assuming that Congress cannot dictate how many workers are hired at the mandated wage, what are the effects of this law? Specifically, calculate what happens to the real wage, employment, output, and the total amount earned by workers.

- d. Does Congress succeed in its goal of helping the working class? Explain.
- e. Do you think that this analysis provides a good way of thinking about a minimum-wage law? Why or why not?
6. Suppose that a country experiences a reduction in productivity—that is, an adverse shock to the production function.
- a. What happens to the labor demand curve?
- b. How would this change in productivity affect the labor market—that is, employment, unemployment, and real wages—if the labor market is always in equilibrium?
- c. How would this change in productivity affect the labor market if unions prevent real wages from falling?
7.  **LaunchPad** • Consider an economy with two sectors: manufacturing and services. Demand for labor in manufacturing and services are described by these equations:
- $$L_m = 200 - 6W_m$$
- $$L_s = 100 - 4W_s$$
- where  $L$  is labor (in number of workers),  $W$  is the wage (in dollars), and the subscripts denote the sectors. The economy has 100 workers who are willing and able to work in either sector.
- a. If workers are free to move between sectors, what relationship will there be between  $W_m$  and  $W_s$ ?
- b. Suppose that the condition in part (a) holds and wages adjust to equilibrate labor supply and labor demand. Calculate the wage and employment in each sector.
- c. Suppose a union establishes itself in manufacturing and pushes the manufacturing wage to \$25. Calculate employment in manufacturing.
- d. In the aftermath of the unionization of manufacturing, all workers who cannot get the highly paid union jobs move to the service sector. Calculate the wage and employment in services.
- e. Now suppose that workers have a *reservation wage* of \$15—that is, rather than taking a job at a wage below \$15, they would rather wait for a \$25 union job to open up. Calculate the wage and employment in each sector. What is the economy's unemployment rate?
8. When workers' wages rise, their decision about how much time to spend working is affected in two conflicting ways—as you may have learned in courses in microeconomics. The *income effect* is the impulse to work less, because greater incomes mean workers can afford to consume more leisure. The *substitution effect* is the impulse to work more, because the reward for working an additional hour has risen (equivalently, the opportunity cost of leisure has gone up). Apply these concepts to Blanchard's hypothesis about American and European tastes for leisure. On which side of the Atlantic do income effects appear larger than substitution effects? On which side do the two effects approximately cancel? Do you think it is a reasonable hypothesis that tastes for leisure vary by geography? Why or why not?
9. In any city at any time, some of the stock of usable office space is vacant. This vacant office space is unemployed capital. How would you explain this phenomenon? In particular, which approach to explaining unemployed labor applies best to unemployed capital? Do you think unemployed capital is a social problem? Explain your answer.

For any problem marked with  **LaunchPad**, there is a Work It Out online tutorial available for a similar problem. To access these interactive, step-by-step tutorials and other resources, visit LaunchPad for *Macroeconomics* 9e at [www.macmillanhighered.com/launchpad/mankiw9e](http://www.macmillanhighered.com/launchpad/mankiw9e)