

Assessing Costs of Unemployment-- Labor Economics

by Sophia Tutorial



WHAT'S COVERED

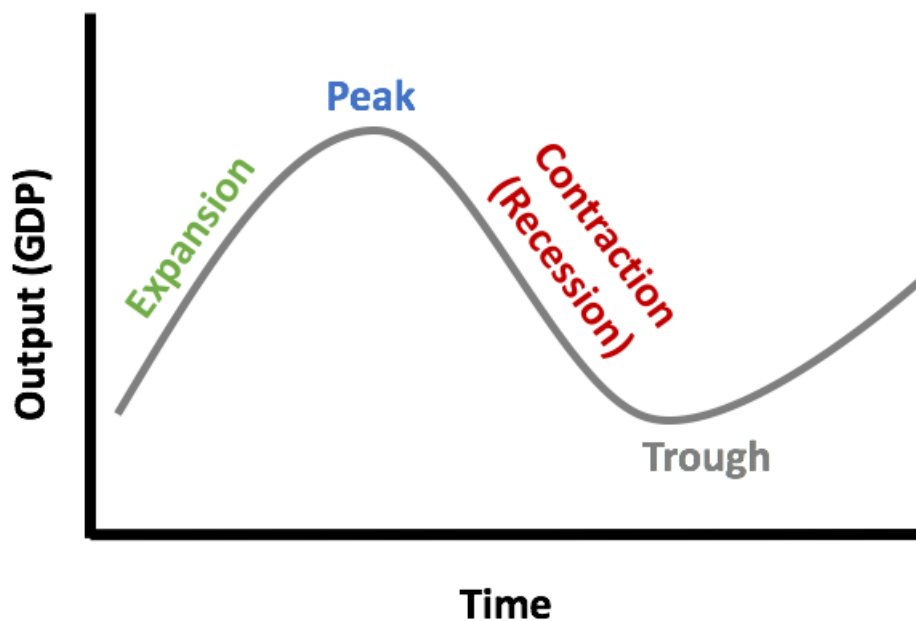
This tutorial will discuss assessing costs of unemployment, focusing on labor economics. We will define and explain different types of unemployment--frictional, structural, and cyclical--and understand that the natural rate of unemployment is when the economy is operating at full capacity.

Our discussion breaks down as follows:

1. Business Cycle
2. Types of Unemployment
 - a. Frictional Unemployment
 - b. Structural Unemployment
 - c. Cyclical Unemployment
3. Full Employment/Natural Rate of Unemployment
4. Thoughts on Unemployment

1. Business Cycle

Here is a business cycle. With the rate of growth in the economy, which is measured by GDP or output on the y-axis, and time on the x-axis, you can see that it is natural for the economy to go through periods of growth and contraction.



Notice the period of expansion leading into a peak, followed by a contraction.

If the contraction lasts six months or longer, we typically say we are in a recession. If it lasts a really long time, then we may call it a depression. After the period of contraction, we hit a trough, and the whole cycle starts over again.

Most people are concerned about things such as unemployment and inflation.

Even as we go up and down, despite the fact that this is normal, people are always concerned about it.

Economists use many different kinds of data to help them do the following:

- Predict where the economy is headed
- Explain what has just occurred in the economy
- Look at what is currently happening in the economy

In other words, we look forward, we look back, and we look at right now.

One of the biggest things that economists will do is calculate unemployment. Calculating unemployment and understanding it is a big part of this business cycle.

Unemployment tends to rise during periods of contraction and fall during a period of economic growth or expansion.

2. Types of Unemployment

It is important to understand that there are different kinds of unemployment.



THINK ABOUT IT

When news sources state that the unemployment rate is 7.8%, for example, what does that mean? What kinds of unemployment are people actually experiencing?

Depending on the cause of unemployment or the type of unemployment, the government may or may not want to take action.

2a. Frictional Unemployment

The first type of unemployment we will discuss is **frictional unemployment**, which is defined as natural separation from employment.

This underlies the "natural rate of unemployment," which we will address shortly. This is where employees are looking for positions that are, in fact, available.

This type of unemployment is normal and will always exist. We will always have a certain level of the population frictionally unemployed.

➦ **EXAMPLE** For example, a recent college graduate is not necessarily going to find a job immediately the day they graduate. The same applies to people who are making career changes, which happens all the time. It is going to take some time to interview and make that change. Lastly, people relocating to a different city may be temporarily unemployed.

These are just three examples, but as you can tell, these are normal life events. It is natural separation from the labor force for a short period of time, and it doesn't indicate that anything is wrong with the economy, because they are looking for jobs that are, in fact, out there.



TERM TO KNOW

Frictional Unemployment

Natural separation from employment; underlies the "natural rate of unemployment." Employees looking for positions that are available

2b. Structural Unemployment

Structural unemployment is different. Structural unemployment is the unemployment resulting from changes in the structure of the economy.

Our economy is constantly changing in how we produce goods and services.

Structural unemployment can result from people's skills not matching the skills necessary for jobs. It can be caused by new technology, new resources, changes in consumer demand, globalization, or a lack of education.

IN CONTEXT

A classic example of structural unemployment involves the invention of computers, whereby a change in technology displaced, for example, typewriter repairers.

People were not using typewriters anymore, so there was no longer a need for people to repair them.

Those people would be structurally unemployed, because the economy changed the way that we do things. Therefore, they would need to potentially get more training and would need to change their

skill set to get a new job.

Again, although this type of unemployment can be very difficult for people, it does not suggest that anything is wrong with the economy.

In reality, it would not be desirable for our economy to stay completely stagnant and not change or update how we do things.



TERM TO KNOW

Structural Unemployment

Unemployment resulting from changes in the structure of the economy

2c. Cyclical Unemployment

Cyclical unemployment is the type of unemployment that follows the business cycle we reviewed at the beginning of the lesson.

It falls when the economy is in an expansion, and it increases as the economy goes through a contraction or recession.

This is the type of unemployment that we see whenever our economy slows. When we hear that we are in a recession or a depression, generally speaking, we have fairly high unemployment rates during those times.



TERM TO KNOW

Cyclical Unemployment

Unemployment that follows the business cycle; falls as the economy expands and increases as the economy slows

3. Full Employment/Natural Rate of Unemployment

Some unemployment is inevitable, and for that reason, full employment does not ever mean that there is 0% unemployment.

We have never had a 0% unemployment rate. In fact, although this seems odd, we wouldn't necessarily want to have 0% unemployment.

If unemployment went that low, there would be dramatic amounts of inflation. It would put so much upward pressure on prices that it would not actually be desirable.

This leads us to the concept of full employment, which takes into consideration the production capacity of the economy at any given point in time.

Full employment is the best case scenario. It is what the economy can bear, given resource and production constraints.

As new technologies are developed and our economy can sustain permanent growth, more people can be employed as these constraints are adjusted over time.

Natural unemployment, then, is defined as the unemployment rate consistent with this concept of full employment.

Typically, it is considered to be around 5% and attributed to frictional unemployment.

This is the unemployment that occurs naturally due to imperfect information or people changing jobs.

As mentioned, the rate of unemployment when our economy is operating at full capacity is somewhere around 5%, though economists have debated whether it could go as low as 4% or as high as 6%.

Once unemployment reaches a level significantly higher than 5%, we know that we are experiencing cyclical unemployment--that type of unemployment where businesses are not hiring people anymore because they are not facing as much demand since the economy has slowed.



TERM TO KNOW

Natural Unemployment

The unemployment rate consistent with full employment; typically considered to be 5% and attributed to frictional unemployment

4. Thoughts on Unemployment

Now, here are a couple of thoughts on unemployment for you to consider.

If we think about sustainable business practices, would there not be long-run benefits to businesses of retaining their workers, because that would create stability of spending in the economy?

The problem is as soon as some businesses begin to lay off workers, it is very cyclical, as we saw on the business cycle.

As soon as some workers are laid off, now they don't have money to spend, which creates an even further decline in demand for goods and services.

Now more employers lay off workers and the cycle continues.

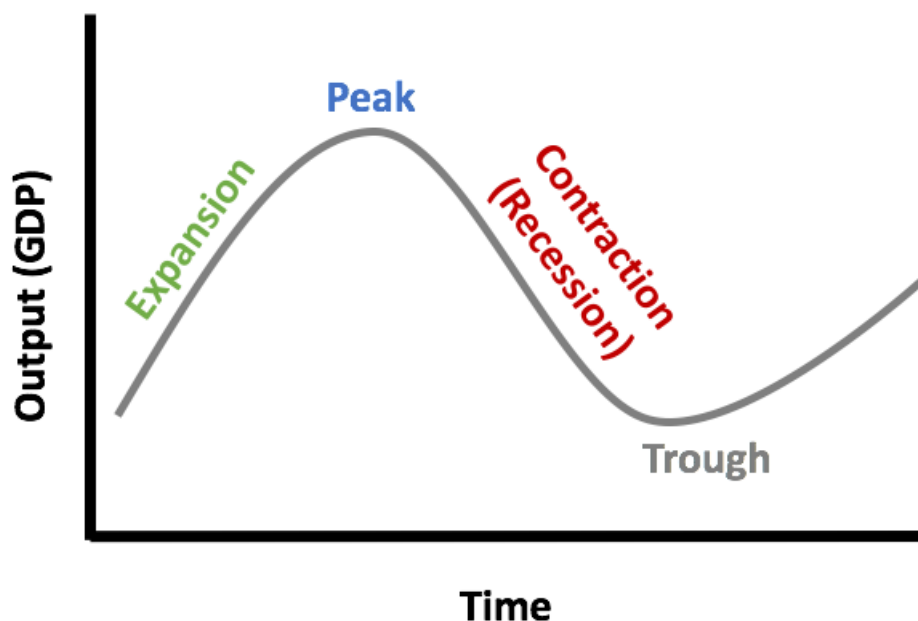
If only there was a way to somehow get businesses to understand that if they just retained workers, it would create more stable spending in the economy.

However, everyone is doing what is in their best interests--and their best interests are profitability. Therefore, these practices have not been adopted by public companies.

When it comes to financial reporting, sometimes companies have to make job cuts in a given quarter to reduce costs in an effort to meet profitability that quarter, because they have to produce their financial reports on a quarterly basis.

Here is the business cycle again.

Remember, we see unemployment rise during contractions and fall during expansions.



Is this counterintuitive? It is a question to ponder, because if we employed more workers, this would cause economic recovery; keeping employees would be beneficial for earnings consistency.

Yet, as mentioned, unemployment rises during recessions and falls during expansions.



SUMMARY

We began today's lesson by reviewing the **business cycle** and noting that calculating unemployment and understanding it is a big part of this business cycle. We learned that there are different **types of unemployment**: **frictional unemployment**, **structural unemployment**, and **cyclical unemployment**. We also learned about **full employment** and how the **natural rate of unemployment** is when the economy is operating at full capacity. Remember, we typically see that to be somewhere around 5%. Lastly, we discussed some **thoughts on unemployment** that are worth giving some additional consideration.

Source: Adapted from Sophia instructor Kate Eskra.



TERMS TO KNOW

Cyclical Unemployment

Unemployment that follows the business cycle; falls as the economy expands and increases as the economy slows.

Frictional Unemployment

Natural separation from employment; underlies the "natural rate of unemployment." Employees looking for positions that are available.

Natural Unemployment

The unemployment rate consistent with full employment; typically considered to be 5% and attributed to frictional unemployment.

Structural Unemployment

Unemployment resulting from changes in the structure of the economy.