



# What Causes Changes in Unemployment over the Long Run

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Cyclical unemployment explains why unemployment rises during a recession and falls during an economic expansion. But what explains the remaining level of unemployment even in good economic times? Why is the unemployment rate never zero? Even when the U.S. economy is growing strongly, the unemployment rate only rarely dips as low as 4%. Moreover, the discussion earlier in this chapter pointed out that unemployment rates in many European countries like Italy, France, and Germany have often been remarkably high at various times in the last few decades. Why does some level of unemployment persist even when economies are growing strongly? Why are unemployment rates continually higher in certain economies, through good economic years and bad? Economists have a term to describe the remaining level of unemployment that occurs even when the economy is healthy: it is called the natural rate of unemployment.

## **The Long Run: The Natural Rate of Unemployment**

The natural rate of unemployment is not “natural” in the sense that water freezes at 32 degrees Fahrenheit or boils at 212 degrees Fahrenheit. It is not a physical and unchanging law of nature. Instead, it is only the “natural” rate because it is the unemployment rate that would result from the combination of economic, social, and political factors that exist at a time—assuming the economy was neither booming nor in recession. These forces include the usual pattern of companies expanding and contracting their workforces in a dynamic economy, social and economic forces that affect the labor market, or public policies that affect either the eagerness of people to work or the willingness of businesses to hire. Let’s discuss these factors in more detail.

## **Frictional Unemployment**

In a market economy, some companies are always going broke for a variety of reasons: old technology; poor management; good management that happened to make bad decisions; shifts in tastes of consumers so that less of the firm's product is desired; a large customer who went broke; or tough domestic or foreign competitors. Conversely, other companies will be doing very well for just the opposite reasons and looking to hire more employees. In a perfect world, all of those who lost jobs would immediately find new ones. But in the real world, even if the number of job seekers is equal to the number of job vacancies, it takes time to find out about new jobs, to interview and figure out if the new job is a good match, or perhaps to sell a house and buy another in proximity to a new job. The unemployment that occurs in the meantime, as workers move between jobs, is called frictional unemployment. Frictional unemployment is not inherently a bad thing. It takes time on part of both the employer and the individual to match those looking for employment with the correct job openings. For individuals and companies to be successful and productive, you want people to find the job for which they are best suited, not just the first job offered.

In the mid-2000s, before the recession of 2008–2009, it was true that about 7% of U.S. workers saw their jobs disappear in any three-month period. But in periods of economic growth, these destroyed jobs are counterbalanced for the economy as a whole by a larger number of jobs created. In 2005, for example, there were typically about 7.5 million unemployed people at any given time in the U.S. economy. Even though about two-thirds of those unemployed people found a job in 14 weeks or fewer, the unemployment rate did not change much during the year, because those who found new jobs were largely offset by others who lost jobs.

Of course, it would be preferable if people who were losing jobs could immediately and easily move into the new jobs being created, but in the real world, that is not possible. Someone who is laid off by a textile mill in South Carolina cannot turn around and immediately start working for a textile mill in California. Instead, the adjustment process happens in ripples. Some people find new jobs near their old ones, while others find that they must move to new locations. Some people can do a very similar job with a different company, while others must start new career paths. Some people may be near retirement and decide to look only for part-time work, while others want an employer that offers a long-term career path. The frictional unemployment that results from people moving between jobs in a dynamic economy may account for one to two percentage points of total unemployment.

The level of frictional unemployment will depend on how easy it is for workers to learn about alternative jobs, which may reflect the ease of communications about job prospects in the economy. The extent of frictional unemployment will also depend to

some extent on how willing people are to move to new areas to find jobs—which in turn may depend on history and culture.

Frictional unemployment and the natural rate of unemployment also seem to depend on the age distribution of the population. [\[link\]](#) (b) showed that unemployment rates are typically lower for people between 25–54 years of age than they are for those who are either younger or older. “Prime-age workers,” as those in the 25–54 age bracket are sometimes called, are typically at a place in their lives when they want to have a job and income arriving at all times. But some proportion of those who are under 30 may still be trying out jobs and life options and some proportion of those over 55 are eyeing retirement. In both cases, the relatively young or old tend to worry less about unemployment than those in-between, and their periods of frictional unemployment may be longer as a result. Thus, a society with a relatively high proportion of relatively young or old workers will tend to have a higher unemployment rate than a society with a higher proportion of its workers in middle age.

### **Structural Unemployment**

Another factor that influences the natural rate of unemployment is the amount of structural unemployment. The structurally unemployed are individuals who have no jobs because they lack skills valued by the labor market, either because demand has shifted away from the skills they do have, or because they never learned any skills. An example of the former would be the unemployment among aerospace engineers after the U.S. space program downsized in the 1970s. An example of the latter would be high school dropouts.

Some people worry that technology causes structural unemployment. In the past, new technologies have put lower skilled employees out of work, but at the same time they create demand for higher skilled workers to use the new technologies. Education seems to be the key in minimizing the amount of structural unemployment. Individuals who have degrees can be retrained if they become structurally unemployed. For people with no skills and little education, that option is more limited.

### **Natural Unemployment and Potential Real GDP**

The natural unemployment rate is related to two other important concepts: full employment and potential real GDP. The economy is considered to be at full employment when the actual unemployment rate is equal to the natural unemployment. When the economy is at full employment, real GDP is equal to potential real GDP. By contrast, when the economy is below full employment, the unemployment rate is greater than the natural unemployment rate and real GDP is less than potential. Finally, when the economy is above full employment, then the unemployment rate is less than the natural

unemployment rate and real GDP is greater than potential. Operating above potential is only possible for a short while, since it is analogous to all workers working overtime.

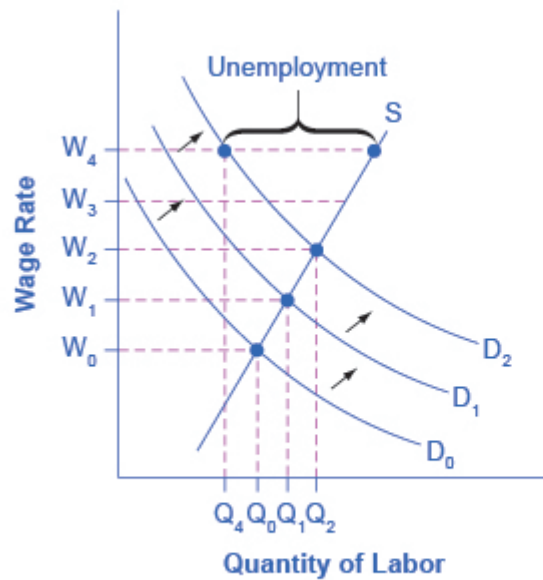
## **Productivity Shifts and the Natural Rate of Unemployment**

Unexpected shifts in productivity can have a powerful effect on the natural rate of unemployment. Over time, the level of wages in an economy will be determined by the productivity of workers. After all, if a business paid workers more than could be justified by their productivity, the business will ultimately lose money and go bankrupt. Conversely, if a business tries to pay workers less than their productivity then, in a competitive labor market, other businesses will find it worthwhile to hire away those workers and pay them more.

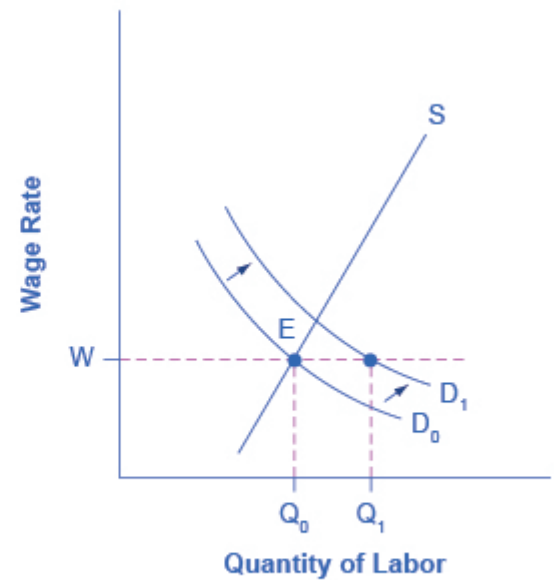
However, adjustments of wages to productivity levels will not happen quickly or smoothly. Wages are typically reviewed only once or twice a year. In many modern jobs, it is difficult to measure productivity at the individual level. For example, how precisely would one measure the quantity produced by an accountant who is one of many people working in the tax department of a large corporation? Because productivity is difficult to observe, wage increases are often determined based on recent experience with productivity; if productivity has been rising at, say, 2% per year, then wages rise at that level as well. However, when productivity changes unexpectedly, it can affect the natural rate of unemployment for a time.

The U.S. economy in the 1970s and 1990s provides two vivid examples of this process. In the 1970s, productivity growth slowed down unexpectedly (as discussed in [Economic Growth](#)). For example, output per hour of U.S. workers in the business sector increased at an annual rate of 3.3% per year from 1960 to 1973, but only 0.8% from 1973 to 1982. [\[link\]](#) (a) illustrates the situation where the demand for labor—that is, the quantity of labor that business is willing to hire at any given wage—has been shifting out a little each year because of rising productivity, from  $D_0$  to  $D_1$  to  $D_2$ . As a result, equilibrium wages have been rising each year from  $W_0$  to  $W_1$  to  $W_2$ . But when productivity unexpectedly slows down, the pattern of wage increases does not adjust right away. Wages keep rising each year from  $W_2$  to  $W_3$  to  $W_4$ . But the demand for labor is no longer shifting up. A gap opens where the quantity of labor supplied at wage level  $W_4$  is greater than the quantity demanded. The natural rate of unemployment rises; indeed, in the aftermath of this unexpectedly low productivity in the 1970s, the national unemployment rate did not fall below 7% from May, 1980 until 1986. Over time, the rise in wages will adjust to match the slower gains in productivity, and the unemployment rate will ease back down. But this process may take years.

## What Causes Changes in Unemployment over the Long Run



(a) Productivity rises, and then stops rising



(b) Productivity doesn't change, and then rises

### *Unexpected Productivity Changes and Unemployment*

(a) Productivity is rising, increasing the demand for labor. Employers and workers become used to the pattern of wage increases. Then productivity suddenly stops increasing. However, the expectations of employers and workers for wage increases do not shift immediately, so wages keep rising as before. But the demand for labor has not increased, so at wage  $W_4$ , unemployment exists where the quantity supplied of labor exceeds the quantity demanded. (b) The rate of productivity increase has been zero for a time, so employers and workers have come to accept the equilibrium wage level ( $W$ ). Then productivity increases unexpectedly, shifting demand for labor from  $D_0$  to  $D_1$ . At the wage ( $W$ ), this means that the quantity demanded of labor exceeds the quantity supplied, and with job offers plentiful, the unemployment rate will be low.

The late 1990s provide an opposite example: instead of the surprise decline in productivity in the 1970s, productivity unexpectedly rose in the mid-1990s. The annual growth rate of real output per hour of labor increased from 1.7% from 1980–1995, to an annual rate of 2.6% from 1995–2001. Let's simplify the situation a bit, so that the economic lesson of the story is easier to see graphically, and say that productivity had not been increasing at all in earlier years, so the intersection of the labor market was at point E in [\[link\]](#) (b), where the demand curve for labor ( $D_0$ ) intersects the supply curve for labor. As a result, real wages were not increasing. Now, productivity jumps upward, which shifts the demand for labor out to the right, from  $D_0$  to  $D_1$ . At least for a time, however, wages are still being set according to the earlier expectations of no productivity growth, so wages do not rise. The result is that at the prevailing wage level ( $W$ ), the quantity of labor demanded ( $Q_d$ ) will for a time exceed the quantity of labor supplied ( $Q_s$ ), and unemployment will be very low—actually below the natural level of unemployment for a time. This pattern of unexpectedly high productivity helps to explain why the unemployment rate stayed below 4.5%—quite a low level by historical standards—from 1998 until after the U.S. economy had entered a recession in 2001.

Average levels of unemployment will tend to be somewhat higher on average when productivity is unexpectedly low, and conversely, will tend to be somewhat lower on average when productivity is unexpectedly high. But over time, wages do eventually adjust to reflect productivity levels.

## Public Policy and the Natural Rate of Unemployment

Public policy can also have a powerful effect on the natural rate of unemployment. On the supply side of the labor market, public policies to assist the unemployed can affect how eager people are to find work. For example, if a worker who loses a job is guaranteed a generous package of unemployment insurance, welfare benefits, food stamps, and government medical benefits, then the opportunity cost of being unemployed is lower and that worker will be less eager to seek a new job.

What seems to matter most is not just the amount of these benefits, but how long they last. A society that provides generous help for the unemployed that cuts off after, say, six months, may provide less of an incentive for unemployment than a society that provides less generous help that lasts for several years. Conversely, government assistance for job search or retraining can in some cases encourage people back to work sooner. See the Clear it Up to learn how the U.S. handles unemployment insurance.

How does U.S. unemployment insurance work?

Unemployment insurance is a joint federal–state program, established by federal law in 1935. The federal government sets minimum standards for the program, but most of the administration is done by state governments.

The funding for the program is a federal tax collected from employers. The federal government requires that the tax be collected on the first \$7,000 in wages paid to each worker; however, states can choose to collect the tax on a higher amount if they wish, and 41 states have set a higher limit. States can choose the length of time that benefits will be paid, although most states limit unemployment benefits to 26 weeks—with extensions possible in times of especially high unemployment. The fund is then used to pay benefits to those who become unemployed. Average unemployment benefits are equal to about one-third of the wage earned by the person in his or her previous job, but the level of unemployment benefits varies considerably across states.

Average Weekly Unemployment Benefits by State in 2013(Source: [jobsearch.about.com/od/unemployment/a/weekly-unemployment-benefits.htm](http://jobsearch.about.com/od/unemployment/a/weekly-unemployment-benefits.htm))

Bottom 10 States that pay the Lowest Benefit per Week	Top 10 States that pay the Highest Benefit per week		
Georgia	\$330	Massachusetts	\$653

## What Causes Changes in Unemployment over the Long Run

Bottom 10 States that pay the Lowest Benefit per Week	Top 10 States that pay the Highest Benefit per week		
South Carolina	\$326	Washington	\$604
Missouri	\$320	New Jersey	\$600
South Dakota	\$295	Minnesota	\$585
Florida	\$275	Pennsylvania	\$573
Tennessee	\$275	Rhode Island	\$566
Alabama	\$265	Hawaii	\$560
Louisiana	\$258	Connecticut	\$555
Arizona	\$240	Ohio	\$524
Mississippi	\$235	Oregon	\$507

One other interesting thing to note about the classifications of unemployment—an individual does not have to collect unemployment benefits to be classified as unemployed. While there are statistics kept and studied relating to how many people are collecting unemployment insurance, this is not the source of unemployment rate information.

View this [article](#) for an explanation of exactly who is eligible for unemployment benefits.



On the demand side of the labor market, government rules social institutions, and the presence of unions can affect the willingness of firms to hire. For example, if a government makes it hard for businesses to start up or to expand, by wrapping new businesses in bureaucratic red tape, then businesses will become more discouraged about hiring. Government regulations can make it harder to start a business by requiring that a new business obtain many permits and pay many fees, or by restricting the types and quality of products that can be sold. Other government regulations, like zoning laws, may limit where business can be done, or whether businesses are allowed to be open during evenings or on Sunday.

Whatever defenses may be offered for such laws in terms of social value—like the value some Christians place on not working on Sunday—these kinds of restrictions impose a barrier between some willing workers and other willing employers, and thus contribute to a higher natural rate of unemployment. Similarly, if government makes it difficult to fire or lay off workers, businesses may react by trying not to hire more workers than strictly necessary—since laying these workers off would be costly and difficult. High minimum wages may discourage businesses from hiring low-skill workers. Government rules may encourage and support powerful unions, which can then push up wages for union workers, but at a cost of discouraging businesses from hiring those workers.

### **The Natural Rate of Unemployment in Recent Years**

The underlying economic, social, and political factors that determine the natural rate of unemployment can change over time, which means that the natural rate of unemployment can change over time, too.

Estimates by economists of the natural rate of unemployment in the U.S. economy in the early 2000s run at about 4.5 to 5.5%. This is a lower estimate than earlier. Three of the common reasons proposed by economists for this change are outlined below.

1. The Internet has provided a remarkable new tool through which job seekers can find out about jobs at different companies and can make contact with relative ease. An Internet search is far easier than trying to find a list of local employers and then hunting up phone numbers for all of their human resources departments, requesting a list of jobs and application forms, and so on. Social networking sites such as LinkedIn have changed how people find work as well.
2. The growth of the temporary worker industry has probably helped to reduce the natural rate of unemployment. In the early 1980s, only about 0.5% of all workers held jobs through temp agencies; by the early 2000s, the figure had risen above 2%. Temp agencies can provide jobs for workers while they are looking for permanent work. They can also serve as a clearinghouse, helping workers find out about jobs with certain employers and getting a tryout with the employer. For many workers, a temp job is a stepping-stone to a permanent job that they might not have heard about or gotten any other way, so the growth of temp jobs will also tend to reduce frictional unemployment.
3. The aging of the “baby boom generation”—the especially large generation of Americans born between 1946 and 1963—meant that the proportion of young workers in the economy was relatively high in the 1970s, as the boomers entered the labor market, but is relatively low today. As noted earlier, middle-aged workers are far more likely to keep steady jobs than younger workers, a factor that tends to reduce the natural rate of unemployment.



The combined result of these factors is that the natural rate of unemployment was on average lower in the 1990s and the early 2000s than in the 1980s. The Great Recession of 2008–2009 pushed monthly unemployment rates above 10% in late 2009. But even at that time, the Congressional Budget Office was forecasting that by 2015, unemployment rates would fall back to about 5%.

### **The Natural Rate of Unemployment in Europe**

By the standards of other high-income economies, the natural rate of unemployment in the U.S. economy appears relatively low. Through good economic years and bad, many European economies have had unemployment rates hovering near 10%, or even higher, since the 1970s. European rates of unemployment have been higher not because recessions in Europe have been deeper, but rather because the conditions underlying supply and demand for labor have been different in Europe, in a way that has created a much higher natural rate of unemployment.

Many European countries have a combination of generous welfare and unemployment benefits, together with nests of rules that impose additional costs on businesses when they hire. In addition, many countries have laws that require firms to give workers months of notice before laying them off and to provide substantial severance or retraining packages after laying them off. The legally required notice before laying off a worker can be more than three months in Spain, Germany, Denmark, and Belgium, and the legally required severance package can be as high as a year's salary or more in Austria, Spain, Portugal, Italy, and Greece. Such laws will surely discourage laying off or firing current workers. But when companies know that it will be difficult to fire or lay off workers, they also become hesitant about hiring in the first place.

The typically higher levels of unemployment in many European countries in recent years, which have prevailed even when economies are growing at a solid pace, are attributable to the fact that the sorts of laws and regulations that lead to a high natural rate of unemployment are much more prevalent in Europe than in the United States.

### **A Preview of Policies to Fight Unemployment**

The [Government Budgets and Fiscal Policy](#) and [Macroeconomic Policy Around the World](#) chapters provide a detailed discussion of how to fight unemployment, when these policies can be discussed in the context of the full array of macroeconomic goals and frameworks for analysis. But even at this preliminary stage, it is useful to preview the main issues concerning policies to fight unemployment.

The remedy for unemployment will depend on the diagnosis. Cyclical unemployment is a short-term problem, caused because the economy is in a recession. Thus, the preferred solution will be to avoid or minimize recessions. As [Government Budgets and Fiscal](#)

[Policy](#) discusses, this policy can be enacted by stimulating the overall buying power in the economy, so that firms perceive that sales and profits are possible, which makes them eager to hire.

Dealing with the natural rate of unemployment is trickier. There is not much to be done about the fact that in a market-oriented economy, firms will hire and fire workers. Nor is there much to be done about how the evolving age structure of the economy, or unexpected shifts in productivity, will affect the natural rate of unemployment for a time. However, as the example of high ongoing unemployment rates for many European countries illustrates, government policy clearly can affect the natural rate of unemployment that will persist even when GDP is growing.

When a government enacts policies that will affect workers or employers, it must examine how these policies will affect the information and incentives employees and employers have to seek each other out. For example, the government may have a role to play in helping some of the unemployed with job searches. The design of government programs that offer assistance to unemployed workers and protections to employed workers may need to be rethought so that they will not unduly discourage the supply of labor. Similarly, rules that make it difficult for businesses to begin or to expand may need to be redesigned so that they will not unduly discourage the demand for labor. The message is not that all laws affecting labor markets should be repealed, but only that when such laws are enacted, a society that cares about unemployment will need to consider the tradeoffs involved.

### The Mysterious Case of the Missing Candidates

After reading the chapter you might think the current unemployment conundrum may be due to structural unemployment. Indeed, there is a mismatch between the skills employers are seeking and the skills the unemployed possess. But Peter Cappelli has a slightly different view on this—it is called the purple squirrel. The what?

In human resource parlance, a purple squirrel is a job candidate who is a perfect fit for all of the many different responsibilities of a position. A purple squirrel candidate could step into a multi-faceted position with no training and permit the firm to higher fewer people because the worker is so versatile. During the Great Recession, Human Resources (HR) positions were reduced. This means today's hiring managers are drafting job descriptions and requirements without much, if any HR feedback. "It turns out it's typically the case that employers' requirements are crazy, they're not paying enough, or their applicant screening is so rigid that nobody gets through," Cappelli stated in a 2012 Knowledge@Wharton interview about the findings in his book, *Why Good People Can't Find Jobs: Chasing After the Purple Squirrel*. In short, managers are searching for "purple squirrels" when what they really need are just versatile workers. There really is not a shortage of "normal squirrels"—candidates who are versatile

workers. The managers just cannot find them because their requirements, screening processes, and compensation will filter out all but the “purple” ones.

### **Key Concepts and Summary**

The natural rate of unemployment is the rate of unemployment that would be caused by the economic, social, and political forces in the economy even when the economy is not in a recession. These factors include the frictional unemployment that occurs when people are put out of work for a time by the shifts of a dynamic and changing economy and any laws concerning conditions of hiring and firing have the undesired side effect of discouraging job formation. They also include structural unemployment, which occurs when demand shifts permanently away from a certain type of job skill.

### **Self-Check Questions**

Is the increase in labor force participation rates among women better thought of as causing an increase in cyclical unemployment or an increase in the natural rate of unemployment? Why?

The increase in labor supply was a social demographic trend—it was not caused by the economy falling into a recession. Therefore, the influx of women into the work force increased the natural rate of unemployment.

Many college students graduate from college before they have found a job. When graduates begin to look for a job, they are counted as what category of unemployed?

New entrants to the labor force, whether from college or otherwise, are counted as frictionally unemployed until they find a job.

### **Review Questions**

What term describes the remaining level of unemployment that occurs even when the economy is healthy?

What forces create the natural rate of unemployment for an economy?

Would you expect the natural rate of unemployment to be roughly the same in different countries?

Would you expect the natural rate of unemployment to remain the same within one country over the long run of several decades?

What is frictional unemployment? Give examples of frictional unemployment.

## What Causes Changes in Unemployment over the Long Run

What is structural unemployment? Give examples of structural unemployment.

After several years of economic growth, would you expect the unemployment in an economy to be mainly cyclical or mainly due to the natural rate of unemployment? Why?

What type of unemployment (cyclical, frictional, or structural) applies to each of the following:

1. landscapers laid off in response to drop in new housing construction during a recession.
2. coal miners laid off due to EPA regulations that shut down coal fired power
3. a financial analyst who quits his/her job in Chicago and is pursuing similar work in Arizona
4. printers laid off due to drop in demand for printed catalogues and flyers as firms go the internet to promote an advertise their products.
5. factory workers in the U.S. laid off as the plants shut down and move to Mexico and Ireland.

### **Critical Thinking Questions**

Under what condition would a decrease in unemployment be bad for the economy?

Under what condition would an increase in the unemployment rate be a positive sign?

As the baby boom generation retires, the ratio of retirees to workers will increase noticeably. How will this affect the Social Security program? How will this affect the standard of living of the average American?

Unemployment rates have been higher in many European countries in recent decades than in the United States. Is the main reason for this long-term difference in unemployment rates more likely to be cyclical unemployment or the natural rate of unemployment? Explain briefly.

Is it desirable to pursue a goal of zero unemployment? Why or why not?

Is it desirable to eliminate natural unemployment? Why or why not? *Hint:* Think about what our economy would look like today and what assumptions would have to be met to have a zero rate of natural unemployment.

The U.S. unemployment rate increased from 4.6% in July 2001 to 5.9% by June 2002. Without studying the subject in any detail, would you expect that a change of this kind

## What Causes Changes in Unemployment over the Long Run

is more likely to be due to cyclical unemployment or a change in the natural rate of unemployment? Why?

### **Problems**

As the baby boomer generation retires, what should happen to wages and employment? Can you show this graphically?

### **References**

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