Will it stay or will it go?

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When men are employed, they are best contented (Benjamin Franklin).

The objectives of government macroeconomic policy vary over time. For instance, the objective of full employment was associated with the British Labour Party up until the early '80's, while price stability had long been the priority of the Thatcher administrations of the '80's and previous Conservative governments. Given that price stability in Ireland is pursued by the Central Bank, economic growth is generally perceived as the primary policy objective of the government. However, full employment, or rather zero involuntary unemployment, may re-assert itself as the primary policy objective of government macroeconomic policy in this country, as unemployment continues to spiral upwards without bound. This paper will examine the conventional wisdom regarding the failure of the labour market to eliminate involuntary unemployment, and suggest why policy measures to alleviate the problem will entail more hope than expectation.

Whichever view of the non-utilisation of vast quantities of the labour force is taken (unfortunate consequence of necessary anti-inflation policies or the greatest evil in society), it is possible to make some specific assertions about the consequences of unemployment. Unemployment implies the existence of a displacement of the economy from the production possibilities frontier and hence from the utilities possibility frontier. Hence, by definition, the unemployment (and even underemployment) of any quantity of labour (or capital) constitutes a non-Pareto optimum in the economy. In this regard, unemployment, irrespective of economic ideology, is clearly undesirable, and hence the subsequent orientation of policy towards its elimination.

This paper will examine why unemployment prevails in any market economy, and why the labour market may fail to achieve equilibrium. The process by which a conventional tradeable good or service achieves equilibrium in the market is first examined. The prevailing theories regarding labour market disequilibrium will then be reviewed. The characteristics which distinguish labour from conventional goods or services will then be examined, and finally the implications of these distinguishing characteristics for the functioning of the labour market will be assessed.

Market forces

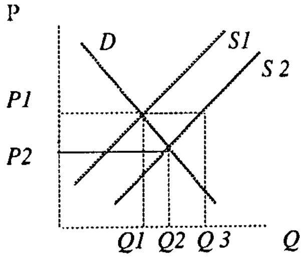

Figure 1

One of the primary contentions of economics is that when the supply of a good is matched by the existence of a demand for that good - that is, individuals are willing to pay a price to consume the good - markets forces, the invisible hand, or the Walrasian auctioneer will ensure that, for an equilibrium price, the quantity demanded will equal the quantity supplied. In Figure 1 the market for a conventional good such as a radio, a haircut or an apple is mapped, where the initial equilibrium is at (P1,Q1). A shock occurs in the market, such as a technological breakthrough, which causes the supply curve to shift outwards from S1 to S2. Initially the price will remain at P1, but, as can be seen from the diagram, this will result in excess supply equivalent to Q3-Q1. Suppliers will be unable to sell all of their output, and inventories will accumulate. In a bid to halt the accumulation, suppliers will reduce prices to increase the quantity demanded. This process of reducing price to halt inventory accumulation will continue until the new equilibrium of (P2,Q2) is achieved.

Conventional wisdom

Were labour such a typical good or service, this process would ensure that the labour market would attain an equilibrium position; unemployment would be voluntary and the economy would move towards (but not necessarily be on) the production possibilities frontier. However, labour does possess distinguishing characteristics which interfere with the mechanism by which equilibrium is achieved. I will outline the primary 'supply-side' traits which frustrate the market's attempts to bring about equilibrium, and will then propose two 'demand-side' factors, which will also act to retard market forces and constrain the ability of the market to equilibrate.

Neo-Classical theory proffers three[1] primary 'supply-side' factors which interfere with the market mechanism; namely income taxes, replacement rates and trade unions. Income taxes and non-discretionary social insurance contributions drive a 'wedge' between the wages paid by the employer and those received by the employee. Effectively, taxes shift the supply curve to the left - the extent of the shift being determined by the level of taxes - thus requiring higher wages to be paid to maintain a given quantity

[1] Job-search is another factor to which unemployment is attributed, but space and time limitations do not permit a thorough discussion of same.

of labour supplied.

Replacement rates also act to distort labour supply. The level of unemployment benefit, social assistance and non-monetary benefits such as medical cards and free travel, will affect the decision of whether or not to accept a job offer. The lower is the *net* benefit (total income while working less total income while unemployed) from taking a job, the lower will be the incentive to take a job, and hence the higher will be the rate of unemployment. Trades unions also 'tamper' with the market mechanism, albeit in a more direct way. The unions can intervene in a number of ways such as the imposition of a minimum wage which *does* create involuntary unemployment, or, minimum qualifications (such as M.R.C.S.I or B.L. from Kings Inn) which *do not.* Herein lies a paradox - for while price cartels and collusion are prohibited by law in most, if not all market economies, trade unions - cartels in the labour market - are not.

New Classical theorists maintain that the existence of differentials between the *expected* and *actual* rates of inflation contribute to the problem. Labour contracts will incorporate a clause to adjust for the rate of inflation to prevent the erosion of the purchasing power of wages, which will typically be based on the expected rate of inflation for the period of the contract. New Keynesian theories propose that it is the manner in which labour is traded - by contract over time - that lies at the root of the unemployment problem. Labour contracts will typically specify the wages for the period of the contract and incorporate a clause by which both sides can terminate the contract as long as a specified length of notice is given. Therefore, if a slump in demand for the output (and by implication labour) occurs, wages will not be able to adjust downwards to their new equilibrium level. Unemployment - involuntary unemployment - will result as employers are left with the thankless job of terminating contracts.

Demand aspects

The primary differentiating characteristic of labour from any other tradeable good or service is its heterogeneity. In the simple supply/ demand analysis presented at the beginning of the paper, it was implicitly assumed that the goods were homogeneous, i.e. that the product supplied by different suppliers was identical. This is evidently not the case for labour. The heterogeneity of footballers, for example, can actually be measured by their transfer prices - while some players are sold for over £5M, others are given free transfers. The output, and hence the supply price, of labour is determined by factors such as education, motivation, personality and other less clear cut factors such as social attitudes. In the labour market it will not be possible to perfectly assess all of these factors, so activity in the labour market will have to operate within the constraints of imperfect information.

The consequence of this is that there exists not one, but a whole series

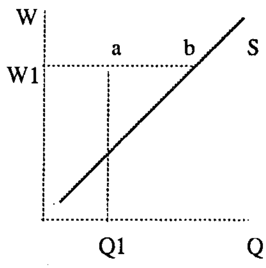

Figure 2

of labour markets for individuals with different skills and qualifications. Therefore, while there may be chronic shortages of French teachers in secondary schools, there could simultaneously be an abundance of German teachers. This will give rise to a new type of undesirable involuntary unemployment, whereby individuals would take up employment at the going wage but are prevented from doing so by their skill shortages.

Heterogeneity also involves other problems. Consider Figure 2 where an employer offers a wage of W1 to attract a labour supply of Q1. This depicts a situation where the employer can set both the price and the quantity as a result of the market power - a demand aspect. But the situation will clearly attract an excess supply of labour equivalent to ab. This situation at first appears to be counter-intuitive as the employer can attract the required amount of labour with a lower wage, but it is here that the characteristic of heterogeneity applies. Excess supply entails the existence of a 'pool' of labour from which the employer chooses those workers which he perceives to have the greatest productivity potential. These demand-side problems prevail in most labour markets to some extent and constitute even more institutional factors which prevent the market from operating as efficiently as it otherwise would.

Conclusion

This paper originally set out to highlight the failures in the sort of thinking which suggests that piecemeal deregulation of the labour market will eliminate involuntary unemployment. The demand-side factors must be surmounted before the labour market will operate as efficiently as conventional markets. One can pessimistically (though realistically) conclude that prospects for countries with large scale unemployment are dim. Their plight will not be resolved by market forces, and the only policy prescriptions I can make are active measures to restrict supply, such as lowering the mandatory retirement age. Failing a fall off in labour supply, I can only conclude by asserting that the return of large scale emigration is the only foreseeable event which will make serious inroads into the unemployment statistics of countries plagued by this affliction.