UNEMPLOYMENT THEORIES & EUROPEAN UNEMPLOYMENT

BUSINESS ECONOMICS ASSIGNMENT

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Introduction

In majority of capitalist economies, many people lack the means of production to cater for their own subsistence and solely depend on selling their labour to the market for survival. Further, those people who possess the means of production to cater for their subsistence are obligated to participate in the labour market for them to settle their tax obligations. As much as neoclassical economists argue that market systems have an inherent tendency to full employment, it has been found out that unemployment is a common feature of any capitalist economy of the modern day. By definition, unemployment can be taken to refer to an economic situation where skilled people actively seeking employment fail to find work (Ball, 1999).

Economists who subscribe to the Post Keynesian school of thought attributes unemployment to problems of effective demand where economies fail to attain full employment and also to structural change problems where even if such economies achieve full employment, they lack the capacity to maintain it. Unemployment in itself has significant social and economic costs that include permanent loss of outputs of goods and services (Piachaud, 1999). The unemployed population faces financial insecurity leading to poverty and other social vices including ethnic antagonism, family disruption and ill health. On the economy, unemployment destabilizes business expectations due to low demand and often leads to technological stagnation. This paper discusses various theories of unemployment and attempts to explain the nature of the current form of unemployment experienced in Europe.

Theories of Unemployment

- **The Classical Theory**

This theory argues that labour market constitutes demand and supply of labour. The labour demand is derived demand obtained from reducing portion of marginal product of labour. The labour demand curve is a negative function of real wages. On the other hand, the supply of labour is derived from an individual's choice on whether to spend time work or leisure. In this case, the labour supply curve is a positive function of real wage. In equilibrium, the intersection of labour demand and labour supply determines the equilibrium real wage and full employment as shown in the figure below.

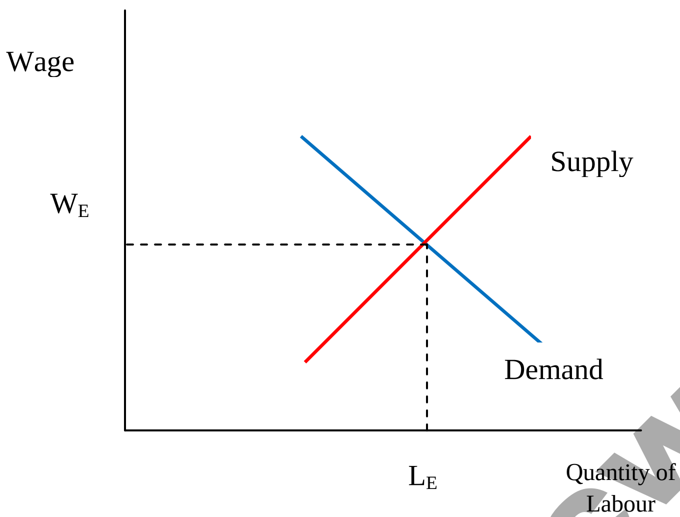

Figure 1: Classical Unemployment Illustration

From the above graph, the equilibrium wage is given by WE while equilibrium quantity of labour supplied is denoted by L_E. In this case, the market is free and determines equilibrium wage and labour and thus there exist no involuntary unemployment. In this case, the economy is assumed to be perfectly competitive and self-adjusting (Smets and Raf, 2003). However, from the above figure, there may exist people who would offer their services on the market if the wages were higher represented by the portion depicted right of the $L_{E.}$. Due to the existing wage rate, such people make rational choice of not participating in this labour market.

On the other hand, this theory argues that involuntary unemployment will exist if the market forces of demand and supply of labour is interfered with. For instance, if a legal minimum wage in a country is enforced, the equilibrium in the labour market is destabilized. As the governments strive to improve the working conditions by setting higher real wages, this figure is normally set above the equilibrium wage rate determined by the forces in the market (Buiter, 2009).

Consequently, the number of individuals seeking employment increases beyond the available employment opportunities leading to unemployment. This can be illustrated below:

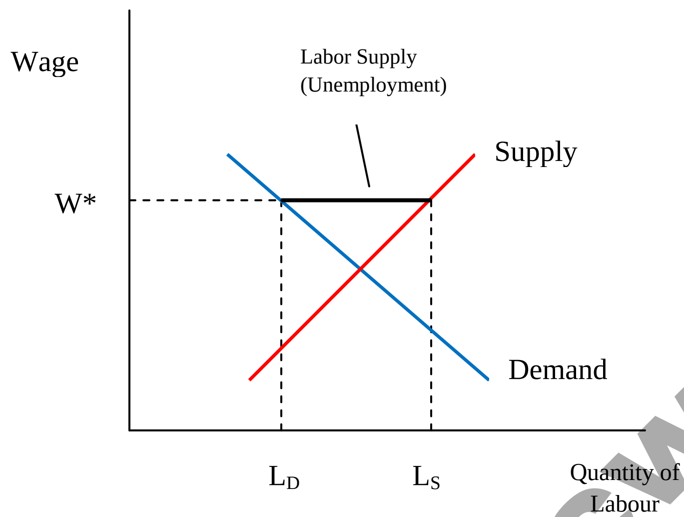

Figure 2: Classical Unemployment Illustration

From this illustration, if a legal minimum wage of W* above equilibrium wage is enforced, this market will hire L_D workers. On the W* wage, the number of people demanding employment opportunities are L_S workers. This means the market will employ fewer people leading to labour surplus, hindering the market from attaining equilibrium and resulting to unemployment.

- **Keynesian Theory**

Keynesian theory premises on a vast assault of the classical theory of unemployment and offers a divergent explanation. According to this theory, the classical theory of unemployment premises on achieving full employment through a balance of demand and supply in the labour market is erroneous. This theory critiques the classical views arguing that full employment cannot be achieved even in equilibrium of demand and supply of the labour market in volatile and unstable economies.

The Keynesian theory suggests that unemployment is caused by lack of sufficient labour demand in the markets leading to excess labour surplus. The theory states that the volume of employment and unemployment depends on the gross domestic product of an economy, meaning that increase in GDP translates to decrease in unemployment and vice versa as shown in the vicious cycle figure below (Shimmer, 2005).

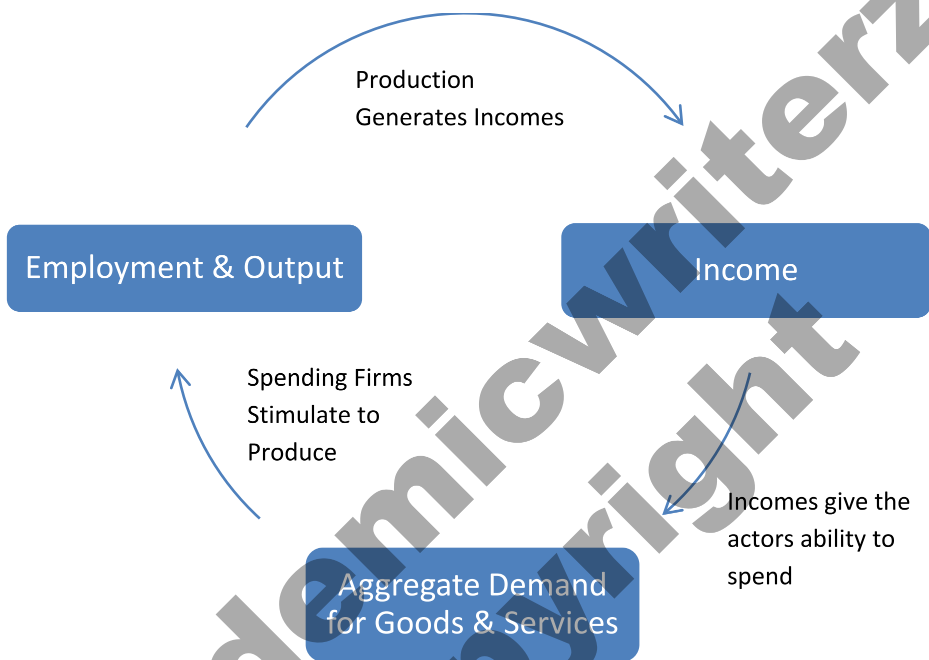

Figure 3: Keynesian Theory Illustration

From the above, the theory proposes increases in aggregate demand that will stimulate hiring in the labour market. Decreases in aggregate demand necessitates decline in production and consequently low demand for labour leading to higher unemployment levels (Christiano et al., 2005). This forces the wages to remain sticky above the equilibrium level resulting to acute unemployment. To solve the emerging unemployment, the theory suggests replacement of missing private with government investments.

- **NAIRU Theory**

The premises of NAIRU theory is based on price bargaining and wage setting. In short run, the equilibrium of income claims by both capital and labour is attained by unanticipated inflation. This implies that prices rise faster than what workers had anticipated at the point of negotiating wages. Consequently, this necessitates redistribution of income (Stockhammer, 2004). In short run, resultant effective demand necessitates higher production and demand for labour hence reducing the level of unemployment.

In the long run, the expectations of workers may be fulfilled thereby income claims become equilibrated through the unemployment rate. This allows the market to adjust itself to corresponding natural level via real balance effect.

Essentially, the 'natural' rate of unemployment (NAIRU) is the unemployment rate that results when there is equilibrium in the labour market but there exist pressures from either decreasing or increasing inflation rates (Blanchard and Wolfers, 2000).

NAIRU model of unemployment can be summarized as below:

Demand $y = a_0 - a_3$p

Employment function $e = \beta_0 + \beta_4$y

Price setting $p = a_0 + x^w$

Wage setting $w = m_{0-}m_{5-(n-e)+\,p}$e

Unemployment $u = n - e$

If expectations are fulfilled, then $\mathrm{u} = \frac{a_0+m_0}{m_5}$

European Unemployment

The European unemployment rate in November 2012 was given at 11.8 percent. This represented an increase of 0.1% from October the same year (Eurostat, 2013). The EU estimates indicate that over 26 million people within Europe are unemployed, with over 18 million coming from euro area in the same period. In comparison to the same period on the previous year, the rate of

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