2.1.3 Employment and unemployment

Notes for Edexcel Economics A, unit 2.1.3 on employment and unemployment
Written by Tom Furber, tfurber.com/edexcel-economics

Contents

How to measure unemployment

Unemployment means the number of **people able and willing to work but who cannot find work.**

The unemployment rate is the percentage of the labour force in unemployment.

The two main measures of unemployment in the UK are:

- **Claimant count** - this relies on the number of people claiming unemployment welfare benefits.
    - This gives a measure at a population level rather than the sample level.
    - However not everyone who is unemployed may claim benefits, for instance due to the stigma associated with welfare.
- **Labour Force Survey** - this survey collects a sample from the population. It then asks the sample whether they are unemployed or not.
    - This method estimates the unemployment rate based on a sample. So the measure may be subject to sampling error.

Note unemployment does not include "**economic inactivity**". Economic inactivity refers to people who are not part of the labour force, meaning they are not looking for work. For example those who retire, students and those who give up looking for work.

Unemployment and underemployment

One criticism of unemployment measures is they do not capture "**underemployment**".

- This refers to workers working part-time but who also want to work more hours.
- Also this applies to workers in a job that does not fit their skills but who want to find a job that matches their skills.
- These workers are counted as employed but could be working more hours or in a job where they could be more productive.
- As a result, unemployment rates, on their own, may not give an accurate indication of the level of “slack” in the labour market.

Changes in the rates of employment, unemployment and inactivity

A rise in employment does not necessarily lead to a fall in unemployment. It depends on the cause of the changes:

- For example, suppose workers decide to retire early, moving from employment to inactivity. Employment would fall, unemployment would remain the same and inactivity would rise.
- Another example is an increase in the size of the population. This could lead to more people in all three categories: more employed (in work), more unemployed (not in work but looking for work) and inactive (not in work and not looking for work).

The rates of employment and unemployment are measured relative to the size of the “labour force”.

The labour force includes those who are employed and unemployed. The labour force does **not** include those who are economically inactive.

Specifically, the formulae for the rates of employment and unemployment are:

- $Employment\ rate\ = \frac{Number\ of\ people\ in\ employment}{Labour\ force}$
- $Unemployment\ rate\ = \frac{Number\ of\ people\ unemployed}{Labour\ force}$

The rate of inactivity is measured as a percentage of the population aged 16-64.

For example, in the period May to July 2025, 21.1% of those aged 16 to 64 were classed as economically inactive (source: ONS).

What are the causes of unemployment?

Structural unemployment is caused when workers' skills and the skills on demand do not match.

- Forces such as technological progress and globalisation leave some workers with skills for which there is no longer demand.
    - For example, the development of robots and AI could replace workers in factories and software engineers.
    - Similarly, global companies may offshore production to developing countries with lower labour costs. This could increase unemployment in developed countries.
    - When workers cannot easily move between sectors due to a lack of skills, this is known as occupational immobility of labour.
- Structural unemployment may also occur because of geographical immobility of labour.
    - This is where labour cannot easily move between regions, for instance due to family ties.
    - This could prevent workers moving to regions where their skills are in demand.
    - Geographical immobility of labour can apply within a country, such as different regions in the UK, or globally with different countries having different unemployment rates.

Cyclical unemployment is due to a fall in aggregate demand.

- This could occur because of a downturn in the economic cycle, such as the 2008 financial crisis or the start of the Covid-19 pandemic. Falls in investment and consumption could drive down aggregate demand for example.
- A fall in aggregate demand may lead to lower real GDP. With less being produced in an economy, firms may not need as much labour.
- As a result, there may be reduced demand for labour, which may increase unemployment.
- This link between the demand for an input, such as labour, and demand for final products (in this case aggregate demand) is known as “derived demand”.

Frictional unemployment refers to individuals between jobs.

- This includes workers who have voluntarily quit their last job and are currently looking for another job.
- Frictional unemployment may be desirable. It suggests workers may be switching jobs to find work that better suits their skills or preferences.
- Some frictional unemployment is inevitable. However, frictional unemployment can be reduced by providing workers information on which jobs are available, for example using job centres or online adverts for jobs.

Seasonal unemployment means workers are unemployed for part of the year.

- This occurs in seasonal industries such as tourism (ski resorts or summer holiday locations).
- When the off-season occurs, there is a fall in demand for hotel stays, flights and guided tours. This reduces demand for labour working in these sectors.
- Demand for hotel staff is derived from demand for hotel stays. This leads to higher unemployment.

Real wage unemployment occurs because the real wage is above the market equilibrium real wage.

- This can occur because of a minimum wage or trade union wage above the free market wage.
    - An increase in the wage increases the cost of hiring, reducing firms' demand for labour and increasing unemployment.
- Alternatively, wages may be "sticky", meaning wages may not adjust in response to changes in supply or demand for labour.
    - This could be because workers use their current wage as a reference point in any wage negotiations for next year's wage.
    - So workers may be unwilling to take pay cuts, meaning firms may have to lay off workers rather than simply giving workers a pay cut.

<u>How does migration affect employment and unemployment?</u>

Migration influences both the demand for and supply of workers (labour).

Increased migration into the UK means there are more consumers in the UK economy.

- This increases aggregate demand (total demand for all goods and services).
- This means more workers are needed to fulfill the extra demand for goods and services. This could boost employment.

Moreover immigration may cause a higher demand for “complementary labour”. Here are a few examples:

- **Complementary construction workers**. An increase in immigration for one type of construction worker (e.g. a day labourer) makes it cheaper and easier to build homes. This increases demand for other types of construction workers such as plumbers.
- **Start businesses**. Immigrants may start businesses. Business owners may need to hire workers, increasing demand for labour.

However, migration into the UK may increase labour supply in the UK.

- This could increase unemployment among workers already in the country.
- This is because of an increase in competition over jobs.
- This assumes migrants’ skills are substitutes for those of workers.

Therefore, the effect of immigration on employment and wages depends on whether migrants are substitutes or complements for other workers.

The significance of skills for employment and unemployment.

Having skills that are in demand is likely to boost demand for workers. This could increase employment and reduce unemployment.

To improve workers’ skills, the government or firms could pay for **worker training**. Improved training for workers can boost employment and lower unemployment.

If workers do not have skills that are in demand, this can lead to **structural unemployment**.

Moreover, training workers in only one skill (in other words, specialisation) could also lead to a risk of structural unemployment. A sudden change in the demand for labour in a particular sector, due to technology replacing workers or firms offshoring production, could lead to unemployment.

What are the effects of unemployment?

Firms:

- Easier to hire workers, as firms have more workers to choose from.
- If there are more unemployed workers competing for the same job, firms may have **greater bargaining power in wage negotiations**. As a result, firms could reduce wages.

Workers:

- There is a **social stigma** associated with being unemployed, which could contribute to mental health issues among those who are unemployed.
- There is a **loss in income** for workers as they lose their jobs.
- If unemployed, workers' skills may deteriorate as they are not making use of skills. This reduces worker productivity, which may make it more difficult for the unemployed to find jobs in the future.
- However, the loss in income may be mitigated to some degree as the unemployed may be eligible for welfare payments from the government. This could include some kind of unemployment benefit.

Consumers:

- Workers are also consumers. So, when workers lose their jobs, their incomes may fall. So **consumption may fall**.
- A fall in aggregate demand (due to higher unemployment reducing consumption) could lead to lower inflation. This could benefit consumers.

Government:

- If there are fewer people in work, there could be a **reduction in tax revenue** from income tax and national insurance contributions.
- Higher unemployment may also increase government spending on welfare benefits, such as unemployment benefits. Government spending on worker training may also increase.
- As a result, the government's **budget deficit** (the extent to which government spending exceeds taxation) could widen.
- This could increase the government's national debt, leading to higher debt interest payments for the government.

Society:

- Workers may lose their incomes after becoming unemployed. The fall in disposable income may reduce consumption, leading to lower aggregate demand and **lower real GDP.**
- **Higher crime and divorce rates** when unemployment rises.
- The economy as a whole may operate **below its productive potential**, as the economy is not making use of all available labour.

Bonus points for unemployment

Managing the consequences of unemployment

- **Structural unemployment - job training**
    - By training workers in new skills, workers can apply to jobs in growing sectors instead of sectors in decline. This can reduce structural unemployment.
- **Cyclical unemployment - fiscal and monetary policy**
    - Where there is cyclical unemployment, the Bank of England could intervene to boost aggregate demand. This could include lower interest rates, to reduce the incentive to save, encouraging consumer spending.
    - Alternatively, the government could intervene by increasing government spending. This could boost aggregate demand too.
    - A rise in aggregate demand due to monetary or fiscal policy could help to correct cyclical unemployment.

Hysteresis:

- When a worker becomes unemployed, they may be more likely to be unemployed in the future.
    - Workers, when unemployed, may **lose their skills** if they are not using them.
    - Employers may also be hesitant to hire workers who have been unemployed for a long time, wondering why there's a large gap in their CV between jobs.
- A rise in unemployment today, even if cyclical, can lead to higher unemployment in the future.
- If workers lose their skills as a result of being unemployed, this could result in slower growth of the economy's productive potential.

Tradeoffs:

- Achieving full employment may come with tradeoffs, such as higher inflation and a widening current account deficit.
- In contrast, high unemployment may lead to **lower inflation and a reduced current account deficit**. This occurs when unemployment is caused by falling aggregate demand.
- A shift left in aggregate demand can lead to a lower price level in equilibrium, bringing down the inflation rate.
- A lower inflation rate domestically, relative to other countries, makes exports more price competitive. This increases export demand, which may lead to higher export revenue, reducing the current account deficit.
- Hence, high unemployment can have consequences for other macroeconomic objectives.
- More on tradeoffs between macroeconomic objectives.

Practice question on unemployment in the style of Edexcel Economics A

Below is a short extract, followed by a practice question on unemployment. The question is written in the style of Edexcel Economics A.

Extract: In February 2020 the unemployment rate in the United States was 3.5%. This increased to 14.9% in April 2020, before falling back to 3.5% in July 2022. In 2020, the Covid-19 pandemic and containment efforts led to businesses closing, leading to some workers being laid off temporarily, particularly in sectors such as restaurants. This time period also saw an acceleration in the adoption of delivery services and remote working software, as well as reduced demand for city centre cafés. These changes to the sectoral structure economy have persisted even after the Covid restrictions were lifted.

Source: US Bureau of Labor Statistics.

Question: With reference to the information provided, discuss **two** possible causes of unemployment in the United States. (12 marks)

Related resources for Edexcel Economics A

Edexcel Economics A notes, model answers and practice questions:
https://tfurber.com/edexcel-economics

Edexcel Economics A Theme 2 notes, model answers and practice questions:
https://tfurber.com/theme-2-edexcel-economics/

Related topics:

- Inflation.
- Aggregate demand.
- Aggregate supply.