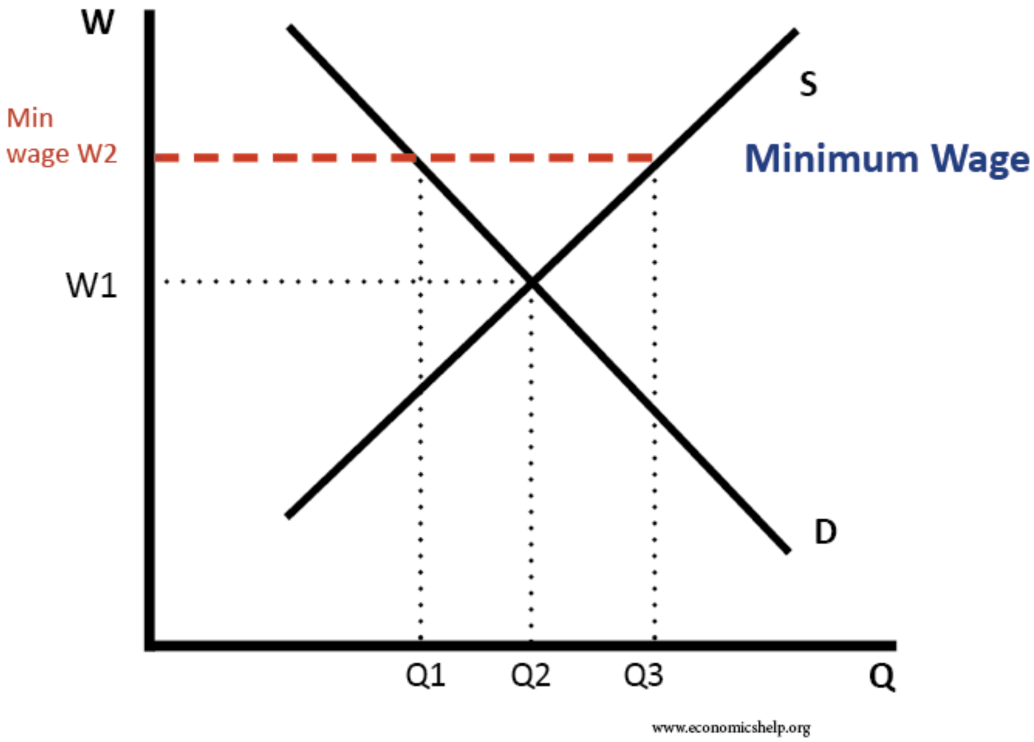
Causes of unemployment

1. Frictional unemployment. This is unemployment caused by people moving between jobs, e.g. graduates or people changing jobs. There will always be some frictional unemployment, as it takes time to find a job.

2. Structural unemployment. This is unemployment due to a mismatch of skills in the labour market. It can be caused by:

- **Occupational immobility**. This refers to the difficulties in learning new skills applicable to a new industry, and technological change. For example, a former manual labourer may find it hard to retrain in a new, high-tech industry.
- **Geographical immobility**. This refers to the difficulty in moving regions to get a job; e.g. someone unemployed in South Wales may find it difficult to move to London, where housing is expensive. We often see higher unemployment in depressed regions.

3. Classical or Real-Wage Unemployment. This occurs when wages in a competitive labour market are pushed above the equilibrium. This could be caused by minimum wages or trade unions.



In a competitive labour market, a minimum wage above the equilibrium will cause real-wage unemployment of Q3-Q1.

- There is concern that a rapid rise in the minimum wage (to a 'living wage') may cause unemployment – especially in low-paid industries, such as catering.

Policies to reduce unemployment

1. Fiscal and monetary policy (demand-side)

If there is demand-deficient unemployment, the government could pursue expansionary fiscal policy by cutting income tax to boost consumer spending and aggregate demand. Higher AD should lead to higher economic growth and should encourage firms to take on more workers.

- However, demand-side policies may cause higher rates of inflation and will not reduce supply-side unemployment, like structural unemployment.

2. Education and training

Structural unemployment could be solved by offering retraining and new skills for the long-term unemployed. This gives a better opportunity for the unemployed to find work in new industries.

- However, it would cost money, and it may prove difficult for some older workers to retrain in new industries and develop new skills.

3. Better job information and interview practice

This could help reduce frictional unemployment by giving the unemployed better information about available job vacancies, and also offering tips for the unemployed to get work.

4. Lower benefits and taxes

Lower benefits and income tax may increase the incentive for the unemployed to look for work rather than stay on benefits. This could reduce frictional unemployment.

- However, benefits in the UK are already quite low; reducing benefits may increase poverty, but will not create any jobs.

5. Reducing minimum wages

If the minimum wage is above the equilibrium, reducing it to the equilibrium will enable firms to employ more workers, which reduces real-wage unemployment.

- However, demand for labour may be quite inelastic; cutting wages may just make firms more profitable.

6. Regional grants

These can help overcome geographical unemployment by encouraging firms to set up in depressed areas, or helping workers to move to areas of high demand.

- However, subsidies may prove ineffective for encouraging workers to move, because they may be attached to their local community. Also, firms may have a similar reluctance to set up in depressed areas because of a lack of infrastructure.

Market Failure

Market failure occurs when there is an inefficient allocation of resources in a free market.

- Complete market failure occurs when the market is missing, e.g. non-provision of public goods like justice and law and order.
- Partial market failure occurs when there is a market for the good, but there is over or under consumption. For example, under-consumption of solar powered electricity which has positive externalities.

Market failure can occur for various reasons.

- **Externalities**. A cost or benefit imposed on a third party, leading to under or over-consumption.
- **Information asymmetries**. Lack of complete knowledge by one party. E.g. people may under-estimate the benefits of education (merit good) or underestimate the costs of smoking (demerit good).
- **Monopoly**. When a firm has market power and can set higher prices. Monopolies may also be more inefficient because they face less competitive pressures.
- **Immobilities**. Geographical immobilities occur when it is difficult for people or firms to move to another area. E.g. unemployed coal miners in Yorkshire find it difficult to move to London because of housing costs. Occupational immobilities occur when it is difficult for people to retrain and get skills in new high-tech industries.
- **Public goods**. Goods that are non-rival and non-excludable.
- **Inequality**. Inequality is a type of market failure. For example, due to unemployment, people may have insufficient income to buy goods.

Public goods

A public good has two characteristics:

- **Non-rivalry**. When a good is consumed, it doesn't reduce the amount available for others, e.g. street lighting.
- **Non- excludability.** This occurs when it is not possible to provide a good without it being possible for others to enjoy, e.g. national defence.
- Examples include law and order, national defence, and street lighting.

Public goods suffer from the **free-rider problem**.

- The free rider problem means that people can enjoy the goods without paying for it. Therefore, there is no incentive for firms to provide goods because it is difficult to charge consumers for using it.
- The consumer can enjoy it for free.
- Public goods usually require the government to provide the good directly and pay for it out of general taxation.

Externalities and social efficiency

Social benefit

- Social benefit is the total benefit to society.
  Social benefit = private benefit + external benefits.
- Social marginal benefit (SMB) = the additional benefit to society of producing an extra unit.
- SMB = PMB (private marginal benefit) + XMB (external marginal benefit)

Social cost

- Social cost is the total cost to society.
  Social cost = private cost + external costs.
- Social marginal cost (SMC) = private marginal cost (PMC) + external marginal cost (XMC)

Negative externality

A negative externality occurs when there is a cost imposed on a third party.

- For example, if a firm produces chemicals, the external cost is the pollution that causes damage to the river.
- If you drive into a town centre, the negative externality is the congestion and pollution that affects other people in the town.
- With a negative externality, the social marginal cost (SMC) is greater than the private marginal cost (PMC).

Diagram of negative production externality