

WHITHER UNEMPLOYMENT?

A review of Yoram Weiss and Gideon Fishelson (eds.), *Advances in the Theory and Measurement of Unemployment*, St. Martin's Press, New York, 1990, ISBN 0-312-02797-4 and Ralf Hussmanns, Farhad Mehran and Vijay Verma *Surveys of Economically Active Population, Employment, Unemployment and Underemployment: An ILO Manual on Concepts and Methods*, International Labour Office, Geneva, 1990, ISBN 92-2-106516-2.

Our understanding and interpretation of unemployment has changed considerably since the 1970s. This development is not surprising in view of the dramatic changes that appear to have occurred in the nature of unemployment in that period. In particular, we have experienced wide-spread increases in measured unemployment that seem resistant to traditional demand management solutions, even in the short term, without severe inflation. Thus higher unemployment, and toleration of higher unemployment as a sensible course for policy-makers, must be explained. As a result, unemployment has returned to the academic and policy spotlight to an extent not witnessed since the Great Depression of the 1930s.

Improved understanding of unemployment, like other social phenomena, requires careful reformulation of theories and better evidence to discriminate among competing theories. Thus researchers should be interested in recent developments in understanding unemployment from a theoretical standpoint and in the development of more accurate measures of unemployment behaviour. Two recently published books provide indications of the state of the art in these two areas of unemployment research. *Advances in the Theory and Measurement of Unemployment* (hereafter *Advances*), is a collection of papers from the Sapir Conference on unemployment held at Tel Aviv University in 1987. The contributors are prominent academic economists in the field of unemployment research and their papers nicely summarize the state of thought about unemployment in the academic community. *Surveys of Economically Active Population, Employment, Unemployment and Underemployment* (hereafter *Surveys*) is an International Labour Organization Manual which reflects the most recently adopted international standards for statistics on labour market activity. Its objective is to summarize international guidelines for gathering data from household surveys on unemployment and other aspects of labour market activity.

Advances and *Surveys* are obviously very different books. *Advances* provides formal analysis of recent theories of unemployment in three areas: search unemployment, efficiency wages, and institutional behaviour (unions and government). *Surveys* provides a careful, but non-mathematical, treatment of the concepts and methods of household surveys of labour market activity. Yet, if substantial progress is to be made in understanding unemployment in the 1990s, these books

should have something to say to one another if we are to avoid an era of untested theories and ill-conceived measurement of unemployment.

Both *Advances* and *Surveys* agree that unemployment is a difficult, yet important, concept to grasp. Unemployment is the “borderline situation . . . between employment and unemployment (EU) [and] between employment and inactivity (EN) . . .” (*Surveys*, p. 44). Moreover, *Surveys* pays comparable attention to underemployment which is defined as “partial lack of work” (p. 121). In considering the measurement of unemployment (chapter 6) and underemployment (chapter 7), considerable attention is devoted to the distinction between “voluntary” and “involuntary” states; that is, whether respondents would prefer at the time of interview to work more hours than they have been offered. This is a concept which has been out of fashion in academic circles because of emphasis on optimal search behaviour (*Advances*, Part 1), but which has been revived in recent years. This revival is clearly reflected in *Advances*: Part 2 considers efficiency wage models while Part 3 examines such institutional considerations as unions and government.

At the heart of the controversy over voluntary and involuntary unemployment is the question of wage flexibility in the labour market. If the labour market clears, unemployment will appear only as the result of unconstrained (i.e. voluntary) behaviour, although that behaviour may be influenced by institutional factors such as unemployment insurance, public provision for child care, etc. In Part 1 of *Advances*, for example, Stern (chapter 1) shows that workers may search too long for job openings, but that an unemployment compensation program and optimal wage tax can be designed in principle to produce socially optimal search behaviour. Mortensen (ch. 3) develops a unified model of the incidence and duration of search unemployment in which workers search both while employed and unemployed. Lay-offs occur when productivity falls and workers “choose” the income from unemployment over the declining offer in the current job; recalls occur when productivity is restored unless a better alternative arises. Part 1 also contains a related paper by Berkovitch (chapter 2) who investigates the adverse, or stigma, effect of unemployment on a worker’s reputation, wage, and probability of leaving unemployment.

The essence of statistical practice in gathering data about unemployment and underemployment is to focus exclusively on quantities, not prices, a practice which may yield consistent statistics but which may have little value for economic analysis. Thus, although search is also an important concept in distinguishing unemployment in *Surveys*, the context is quite different. To be unemployed, respondents are simply required to report any one of the following search activities: registration at an employment exchange, application to employers, checking at work-sites, placing advertisements, checking with friends or relatives, or taking steps to establish self-employment. Although evidence of active search is generally a part of the standard definition of unemployment (p. 98), the search requirement may be relaxed where “conventional means of seeking work are of limited relevance, where the labour market is largely unorganized or of limited scope, where labour absorption is at the time inadequate, or where the labour force is largely self-employed” (p. 105). These exceptions are intended to apply to less developed countries primarily, although it seems to me that they may also

apply to the periphery of developed countries or, in the case of inadequate labour absorption, to any cyclical downturn. Moreover, there is no firm basis for deciding when to abandon the search criterion: it is nothing more than an *ad hoc* decision. Like other *ad hoc* decisions, it will depend on the decision-maker's implicit understanding of the nature and causes of unemployment, something that the data itself is then expected to shed light on.

Debating the use of the search criterion in measuring unemployment involves far more than semantic quibbling. If the search criterion has dubious validity, or if its validity is questionable in certain labour market conditions, then one has to wonder whether the distinction between the unemployed and those out of the labour force, upon which so much of the empirical content of labour economics and macroeconomics rests, has any useful meaning. Clark and Summers (1979) argue that unemployment spells appear to be short because they turn into labour force withdrawals which may be disguised unemployment. Such misleading transformations will occur if the prospective benefits of search are eventually outweighed by the costs so that individuals seeking work decide to "sit out" one or more periods and report no search. Moreover, Jones and Riddell (1991) demonstrate that this confusion between unemployment and nonparticipation may actually be reinforced by standard survey techniques to classify spells of joblessness: "For those individuals who had a period of consecutive search prior to beginning a job *any weeks* of non-employment prior to the period of consecutive job search are coded as weeks of non-participation in the labour force." The result is that earlier spells of active search during the period between jobs are missed, leading to consistent under-reporting of unemployment. *Surveys* seems intentionally vague on what turns out to be an important point, merely stating that "the specific steps for seeking work must have taken place within 'a specified recent period.' The period need not be the same as the basic survey reference period... but may be longer... to take account of the time lags which often follow initial steps to obtain work..." (pp. 99-100).

Another problem is the classification of self-employed work activity. *Surveys* argues that seeking self-employment (i.e. unemployment) and self-employment activity (employment) could be distinguished at the point of formal enterprise registration, but only when registration is required. In other cases, no firm guidelines are possible. For *Advances* such non-standard employment relationships do not seem to exist, although the number of temporary and self-employed workers in non-standard arrangements in the service economy is likely substantial.

Just as it would be easy to argue that there is some under-reporting of unemployment in all current labour force surveys, it would be difficult to argue that all joblessness is unemployment. There is a portion of the population whose entry wage exceeds the prevailing market wage that could be collected. To distinguish between the unemployed and non-participants, however, seems to inevitably lead to price-theoretic demand and supply considerations (with or without equilibrium assumptions). Yet *Surveys* avoids these concepts entirely in developing measures of labour force activity and *Advances* ignores the entire issue. There remains a wide gulf between academic (primarily price-theoretic) analysis and statistical (quantity-based) practice in this area which should generate concern and an international conference or two.

Part 2 of *Advances* considers the case in which the wage which maximizes labour output, the efficiency wage, may not coincide with the market equilibrium wage. Dickens, Katz, Lang and Summers (chapter 6) argue in a short paper that firms must set wages above the equilibrium rate to punish workers for shirking because other methods of ensuring worker performance, including requiring workers to post performance bonds, are not feasible. Akerlof and Katz (chapter 7) consider a long-term labour contract with deferred wage payments as a form of bonding and show that such payments cannot deter shirking at the beginning of a contract. Thus, it may be cheaper to pay a premium on the competitive wage and monitor workers to ensure performance. Murphy and Topel (chapter 8), on the other hand, argue that efficiency wage premia are unnecessary because firms can initially employ workers at jobs requiring very limited monitoring, accumulate a wage “trust fund,” and promote workers to positions requiring extensive monitoring only when the trust fund is sufficient to deter shirking.

Part 3 of *Advances* shifts the discussion to more traditional bases for wage inflexibility. Lazear (chapter 9) shows that government provision for severance pay if workers are discharged acts like a fixed cost per worker and, in the absence of bonding, will discourage full-time employment. His evidence, for 23 countries over 29 years, supports the positive partial correlation between severance legislation and unemployment. Layard and Nickell (chapter 11) show that, in a multi-union bargaining model, the standard result that employment will be higher if unions and firms bargain over employment as well as wages (i.e. contract-curve equilibrium models rather than labour-demand equilibrium models) may not hold because the bargaining threat points of one union are affected by previous bargaining outcomes. Drazen and Gottfries (chapter 12) show that workers seeking to protect their seniority rights may moderate their own wage demands, but pursue an aggressive overall wage policy to create persistent unemployment. Pencavel (chapter 10), however, finds little support for the “classical” view that real wage inflexibility, particularly in Europe because of unions, is associated with higher unemployment. Indeed, countries such as the United States and Canada where employment has grown the most are not characterized by particularly volatile (i.e. flexible?) wages. Thus Parts 2 and 3 reflect to some extent the controversial nature of recent unemployment research and the need for better data and testing of competing models.

One important development in survey research has been the collection of household panel data. *Surveys* notes that definitions of labour market activity are typically based on a short period of observation such as a reference day or week (p. 40). A distinction is made, however, between those “currently active” based on a short reference period and those “usually active” based on a longer period of observation (p. 47). Particular reference is made to seasonal employment patterns, but recent research has demonstrated the importance of retrospective measurement (pp. 59–66) and repeated sampling of households (p. 233–234). Two chapters in *Advances* illustrate the state of research with panel data. Eckstein and Wolpin (chapter 4) provide a useful summary of the theory and empirical results for optimal dynamic search models (as well as models of labour force participation and job matching) using panel data. Coleman (chapter 5) uses the Current Population Survey to dispel the notion that it is primarily differences in

the unemployment experience of different identifiable demographic groups (e.g., blacks or females or youth) which account for the distribution of unemployment in the population. He demonstrates that there is considerable, indeed similar, heterogeneity in the entry and exit rates for unemployment in all demographic groups and that it is a minority in each group with high entry and low exit rates that account for much of the unemployment observed. Such findings may provide a compelling basis for the reassessment of public employment policy, but only if the measured distinction between unemployment and nonparticipation is credible.

Reading these two books together strengthens my conviction that much can be done to improve applied research in unemployment and other aspects of labour market activity. There is little evidence that academics are trying to communicate their insights to statistical agencies or that agencies are seeking the advice of academic specialists in refining survey concepts. Both *Advances* and *Surveys* represent solid research in their own fields, but their contributions to social policy could be much greater with some collaborative work.

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