

Long-Term Unemployment: The Dimensions of the Problem

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1. Introduction

It has been said that within the economics profession there are only two points of broad consensus: that economists never agree, and that economists all agree that reductions in tariffs over the long haul are desirable. Because of different ideological stances, competing theoretical frameworks, and the difficulty of producing unambiguous empirical evidence, we rarely nod in unison. But probably because of the 1980s experience, Australian labour economists—of quite disparate persuasions—now have a new point of consensus.

It is that long-term unemployment has extraordinary social and macroeconomic costs, and needs to be dealt with. Unarguably the members of the long-term unemployed are the most disadvantaged participants in the labour market, with the consequences of having the size of the pool increasing—or at least not falling—affecting us all. This labour market problem is undeniable, stark and profoundly challenging.

This article seeks to illustrate and explain the dimensions of the issue. It is apparent that the existence of a large pool of long-term unemployment makes macroeconomic management very difficult. Forecasts, based on the 1980s experience, of possible future long-term unemployed numbers made in Chapman, Junankar and Kapuscinski (1992, 1993) are highlighted. No attempts are made to compare and contrast possible solutions, with readers being referred to the contributions in this issue of the *Review* by McClelland, McDonald, Quiggin and Sloan.

* The author wishes to acknowledge P. N. Junankar and Barry Hughes for highlighting the long-term unemployment issue, and Cezary Kapuscinski for past technical input. Peter Kenyon, Sarah Came and Connie Cook performed small miracles of communication and editing which are greatly appreciated.

2. An Outline and Explanation of Recent Empirical Experience

There are two major facts about the long-term unemployed. The first is that not long after a recession begins the size of the pool increases considerably. For example, from the beginning of 1981 to September 1983, when the economy was very stagnant, the number rose from about 80 000 to 190 000; similarly from 1990 to 1992 the increase was from 130 000 to 310 000.

The reason this happens is easy to understand. In a healthy economy the vast majority of those unemployed for a short period find jobs. But in a recession, when there are proportionally far fewer jobs being created, the short-term unemployed are much more likely to be still jobless a year later. That is, the 'inflows' to the pool of long-term unemployed go up considerably after a recession begins.

As well, those who are long-term unemployed at the beginning of a recession are very unlikely to find employment in the next short period. In other words, the 'outflows' from the pool to jobs are reduced. The combination of higher inflows to and lower outflows from long-term unemployment helps explain why the number of long-term unemployed has nearly trebled not very long after the onset of the last two recessions.

The other big fact is just as alarming. It is that once a large pool of long-term unemployed exists, on the basis of past experience it is difficult to reduce its size. Rapid economic growth helps, mainly because it stops the pool growing further; but, as illustrated below, growth by itself is not enough.

For example, in the period 1983 to 1990 about 3.3 per cent net jobs were created on average every year, a not unprecedented but highly unusual experience for the Australian economy. Yet at the end of this seven-year period, which saw employment grow by about one and a half million, there were still 110 000 long-term unemployed compared to the initial

number of 190 000. That is, the group which suffered more than the rest of us from the 1982–83 stagnation benefited least from the extraordinary job expansion which followed. The ‘miserable science’ of economics has never been so miserable as it is in this area. Chart A shows the 1980s and early 1990s experience.

The data of Chart A illustrate the basic points. Long-term unemployment increased dramatically after the onset of recession in 1982 and 1990. And long-term unemployed fell only slowly in the halcyon years of job creation from 1984 to 1989.

There are several factors contributing to the obvious challenge in getting long-term unemployment numbers down. As far as the individuals are concerned, it is likely that they eventually reduce job search intensity given a continuing lack of success. Moreover, the long-term unemployed lose contact with the world of paid work, which means that they have less information about upcoming jobs. The evidence is that contact with the world of paid work is a very important asset in the finding of jobs.

But more relevant than what happens to workers is what potential employers think is going on with the long-term unemployed. Rational employers will use ‘signals’ as to the likely productivity of job applicants, with one of these signals being how long a person has been out of work. Being long-term unemployed could suggest to an employer that these particular applicants are inferior workers to the short-

term unemployed, or those who have very recently entered the paid labour force. After all, haven’t they been passed over by a large number of prospective employers in the past? And won’t their lack of contact with paid work mean they have lost skills and developed negative attitudes?

3. Why Does Long-Term Unemployment Matter?

Long-term unemployment is potentially an extremely important issue in two regards. The distributional consequences of ignoring members of this group are fairly clearly strongly adverse (Junankar 1988). Perhaps even more significantly, there are good reasons for believing that having a relatively high proportion of unemployment which is long-term unemployed is associated with major macro-efficiency problems, from the phenomenon labelled ‘hysteresis’.

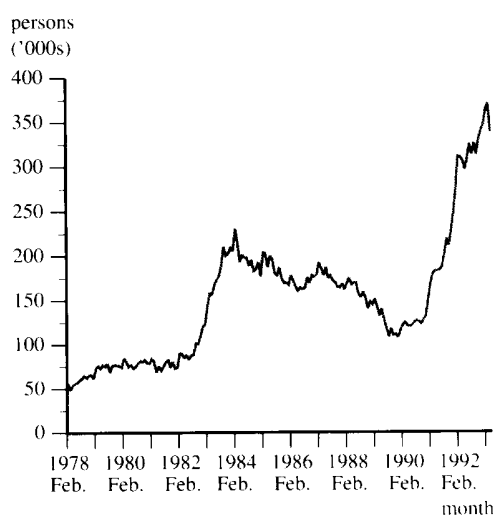
To take the first, the long-term unemployed are disproportionately from the least advantaged part of the labour force. In measured skill terms they are poorly endowed, and with each period of continuing joblessness are probably becoming more so, because of loss of skill and negative attitudinal change.

Second, and a substantial issue for macroeconomic management, is this question of hysteresis, a term used to reflect the possibility that the positioning of the non-accelerating inflation rate of unemployment (NAIRU) depends on the current and recent levels of the unemployment rate. In other words, continuing high levels of joblessness make it less possible for the economy to deliver low levels of inflation and unemployment in the future, essentially because a growing part of the unemployment pool becomes increasingly less relevant to employers. A consequence is that unemployment becomes persistent, responding increasingly less to expansionary shocks to aggregate demand.

Hysteresis can result from having relatively high proportions of the unemployed in long-term unemployment, for several reasons. The first is that if the skills of the long-term unemployed atrophy and/or their attitudes towards work deteriorate, or either of these two possibilities are perceived by employers to be the case, there will be an increasingly less effective match between job vacancies and the nature of the available labour. This is associated with ‘state dependence’, the decreased probability of workers finding employment as their unemployment duration rises.

The other and related reason for hysteresis is that if state dependence is occurring the long-term unemployed will become increasingly less relevant to the

**Chart A Long-Term Unemployment,
February 1978 to February 1993**



Source: ABS, *The Labour Force, Australia*, Cat. no. 6203.0.

wage bargaining process because over time they are in reality, or in the opinion of employers, less substitutable for the employed. This means that with high proportions of long-term unemployed in the unemployment pool, a given level of unemployment dominated by long-term unemployed will have less influence on wage restraint than an unemployment pool with relatively low levels of long-term unemployed.

There is some econometric evidence for the existence of hysteresis in the unemployment data and for the irrelevance of the long-term unemployed to wage determination in Australia. The study by Groenewold and Taylor (1992) finds a strong degree of persistence in employment and therefore, for a given labour force, persistence in unemployment. They also find support for the view that incumbent workers dominate the wage-fixing process and so find little role for the unemployed in affecting (real) wage outcomes. This latter effect was tested directly by Flatau, Lewis and Rushton (1991). They found that the long-term unemployed cease to become part of effective labour supply for the determination of the (real) wage.

Hysteresis poses a profound challenge to the efficient operation of the macro labour market. Its existence implies that continuing high levels of unemployment, associated as they have been with growing—or at least not falling—numbers of long-term unemployed, auger badly for future policy

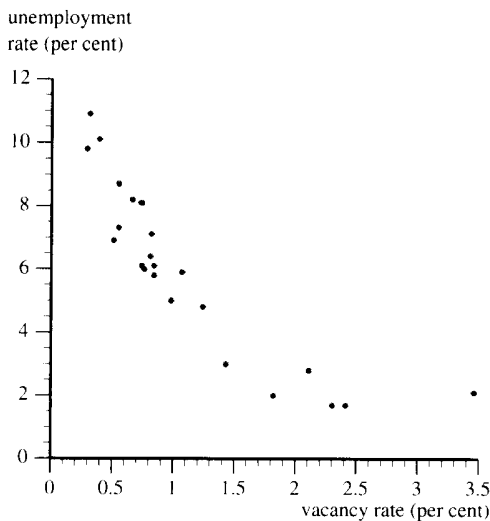
making. Hysteresis implies also a more optimistic perspective: decreasing the rate of unemployment can set in place forces to 'correct' the problems related to past poor employment experience.

There are several sources of evidence suggestive of the role of long-term unemployment in hysteresis. Possibly the clearest, but least statistically rigorous, has been presented in *State of Play 7* (INDECS 1992) with reference to the 'Beveridge Curve', the relationship between unemployment and job vacancy rates. The Beveridge Curve illustrates that in a normally functioning economy there is an inverse (and non-linear) relationship between the number of people unemployed and the available unfilled jobs. That is, when the economy is in a boom the unemployment rate is low and the job vacancy rate high, with the inverse being true for a recession. Chart B shows the empirical regularity of this relationship for Australia, 1966 to 1990, with the data being taken from Chapman (1990).

Interestingly a curious thing seems to have happened to the Australian Beveridge Curve in the 1980s. Chart C—reproduced from *State of Play 7*—shows in a close-up that the unemployment–vacancies relationship changed in ways that are quite consistent with the hysteresis hypothesis outlined above.

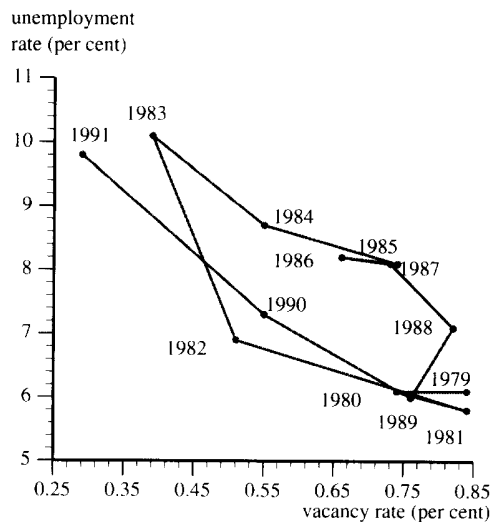
From the chart, it seems that from 1984 to 1988 there was a less propitious matching of the unemployed to vacancies. Referring back to Chart A, it

Chart B The Australian Unemployment–Vacancies Relationship, 1966 to 1990



Source: Chapman (1990).

Chart C The Recent Australian Unemployment–Vacancies Relationship, 1979 to 1991



Source: INDECS (1992).

seems that this less efficient operation of the aggregate labour market has been associated with the increase in and large numbers of long-term unemployed. And part of the correction of the problem occurred in 1989 when long-term unemployment numbers fell considerably.

The tempting conclusion is obvious: vacancies remain higher at any given unemployment rate when there is a high proportion of the available labour supply that seems to be less relevant to the needs of employers in filling jobs. Even so, there are other interpretations in that any increase in structural mismatch within the labour market will cause the Beveridge Curve to shift outwards (Jackman, Pissarides & Savouri 1990).

To put this matter differently, it seems that if the labour market had operated as well in the middle of the 1980s as it previously had, measured levels of unemployment would have been far lower at given rates of labour demand, as measured by job vacancies. For example, eye-balling the data, the unemployment rate could have been around two percentage points lower than that experienced in the mid-1980s if the unemployment–vacancies relationship had not shifted so adversely. This could imply that long-term unemployment affects tax revenue and government expenditure profoundly, and thus all of us.

4. Forecasts of Long-Term Unemployment

Given the obvious potential importance of the above for policy, it is useful to ask what the future course of long-term unemployment might be if the 1980s experience is repeated. Chapman, Junankar and Kapuscinski have made (1992) and updated (1993) forecasts of the likely level of long-term unemployment in the rest of the 1990s on this basis. Because an explanation of the methodology and the data are readily available elsewhere, what follows only highlights the major points.

They are threefold. One, if rapid job growth ensues over the next 18 months or so—in that an unemployment rate of 9.4 per cent is reached by the end of 1994—the absolute number of long-term unemployed will be about 360 000, little different to current levels. Two, if the economy stagnates further such that the unemployment rate rises to 12.4 per cent by the end of 1994, the number of long-term unemployed is forecast to reach 530 000. Three, and

following from points one and two, economic growth is crucial to the outcome: the difference between the high and low scenarios implies that upwards of 170 000 people will not experience long-term unemployment if rapid growth instead of stagnation happens. The attendant social dislocation (see McClelland, this issue) and consequences for macroeconomic management should be clear.

It needs to be pointed out that the forecasts are only valid if history is repeated. However, unlike just after the 1980s recession, it is now obvious that the costs of this experience are both apparent and considerable. The case for a different policy stance which is expressly targeted at the problem is compelling.

May 1993

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Chapman, B. J. (1993), Long-Term Unemployment: The Dimensions of the Problem. Australian Economic Review, 26: 22-25. doi:10.1111/j.1467-8462.1993.tb00778.x

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