Involuntary unemployment: a reminder

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This note sets Keynes's theory of involuntary unemployment against neoclassical and New Classical approaches which fail to go beyond what Keynes described as voluntary unemployment.

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Introduction

In an excellent paper Victor A. Beker ("Rethinking macroeconomics in the light of the US financial crisis," *Real-world Economics Review,* 2012) has drawn attention to the startlingly implausible explanation – offered by certain economic theorists – of why output and employment fell in the recent recession. He is referring to the ideas of the New Classical or Real Business Cycle school which holds that the economy, with rational optimizing agents operating in a context of price flexibility and constantly clearing markets, exhibits a constant state of full employment (albeit with the level of activity corresponding to "full employment" varying from time to time). Citing a recent analysis (Ohanian, 2010) of falling employment in the US, Beker comments:

> "Given the huge level of unemployment the crisis generated, it is not big news to know that the labour input sharply declined during that period. More surprising is the reason for that decline, according to Ohanian: the marginal rate of substitution between consumption and leisure was very low relative to the marginal product of labour. So, it seems that the crisis was caused by a sudden and mysterious increase in the preference for leisure. American workers suddenly decided to stay at home and watch TV instead of going to work. Of course, you are forced to reach that conclusion if you start assuming that the recession is an equilibrium outcome for agents who maximize their utilities. We are now again in a pre-Keynesian world where unemployment is always a voluntary decision by workers who have an increased preference for leisure compared with work" (Beker, 2012).

Beker's theme is that diagnoses of that of that degree of unrealism can only damage the reputation of macroeconomics and that it is high time therefore that this branch of economics was brought into closer contact with the real world. Accordingly he argues that there is a "need to rebuild macroeconomics" on a surer foundation than what would appear to be its present basis – the neoclassical faith that when rational agents operate under conditions of price flexibility the market mechanism can be relied upon to generate an optimal outcome. Beker's recommendation is that macroeconomics must again become "a discipline in which aggregate quantities play an essential role, while prices have only second order effects". Therefore, as he puts it in the concluding paragraph of his paper: "The first step in rethinking macroeconomics would be to rescue Keynes' original ideas".

The author of the present paper is wholly sympathetic to Beker's objective and to his suggested remedy: macroeconomics must be rescued from the trough into which it has fallen, and to achieve that, we need to return to Keynes's understanding of the working of the macrosystem. In fact the problem with contemporary macroeconomics is actually more widespread than might be inferred from Beker's focus on New Classical/RBC theory: mainstream macroeconomics – not only the more exotic New Classical variant – is itself in a poor state. While the New Classical set of ideas may be regarded by a majority of macroeconomists as rather extreme, the alternative "neoclassical" analysis more generally favoured and typically taught in the textbooks – an analysis very possibly described by its proponents as a form of "Keynesian macroeconomics" – is itself far from problem free. This mainstream or orthodox story, despite a superficial dressing in Keynesian language, can readily be shown to be, in essence, much more akin to pre-Keynesian theory than to the revolutionary thesis propounded in the *General Theory*. Essential elements of the Keynes theory disappear from view and in their place emerges a conception which recalls the conventional wisdom of times long past. It must be a potent source of misunderstanding that old "classical" ideas are surreptitiously rehabilitated and presented within a nominally "Keynesian" framework.

The purpose of the present note is to direct attention to Keynes's original analyses (1936; 1939) – nowadays all too frequently overlooked[1] – of the phenomenon of involuntary unemployment. At the present time it is very much worthwhile escaping from both the mainstream neoclassical thinking on the subject and from the more radical New Classical analyses. All such approaches completely ignore the essential – indeed revolutionary – point Keynes was making in the *General Theory* – that involuntary unemployment, as he defined it, resulted from a general deficiency of demand for the output that labour was potentially capable of producing. If workers were thus unemployed, it was not through their own doing: circumstances beyond their control were responsible.[2] It will be, we hope, instructive to notice how Keynes broke away from the conventional approach which focused attention on the conditions of labour supply, recognising instead that the state of demand in the labour market was the key determining factor, and that demand for labour was not simply an independent variable, but ultimately derived from demand for output in the commodities markets.

Involuntary unemployment

It was in the depths of the world-wide economic depression of the inter-war years that J. M. Keynes (in his *General Theory of Employment, Interest and Money*, published in 1936), identified the problem of abnormally high and persisting unemployment as one of *involuntary unemployment.*

He used the defining adjective "involuntary" to emphasise that, on his understanding, and contrary to the conventional view, the heavy unemployment of the time was not the fault of the

[1] On the drift away in recent years from Keynes's theory and the accompanying mainstream return to pre-Keynesian modes of thinking, see Grieve (2014).

[2] By "voluntary" unemployment Keynes meant unemployment which was attributable to the actions of the workforce itself. Thus (1936, p.6): "in addition to 'frictional' unemployment [I recognise the existence of] 'voluntary' unemployment due to the refusal or inability of a unit of labour, as a result of legislation or social practices or of combination for collective bargaining or of slow response to change or of mere human obstinacy, to accept a reward corresponding to the value of the product attributable to its marginal productivity.

unemployed themselves in demanding wages too high to permit their employment, but, on the contrary, of a lack of demand for the output their employment would have produced. If, as was case in the 1930s, employers feared that, for want of demand in the market, they would not be able to sell all the output they potentially could produce, they would not take on workers beyond the number whose output was expected to sell. In such circumstances, workers willing to work on terms compatible with their employment could, through no fault of their own, find themselves without a job. On Keynes's diagnosis, the root of the trouble lay *not* in the labour market, but in the markets for goods and services.

Thus Keynes explained the occurrence of the high level of contemporary unemployment as due to a falling-off in the desire to buy the products of industry, both producer and consumer goods. In particular he saw gloomy expectations of investment prospects and lack of confidence as responsible for a collapse in orders for capital goods, bringing unemployment; and, as employment and earnings in the capital goods sector fell, further contraction of demand and employment resulted throughout the economy. Individual national economies, of the UK, USA, Germany, and indeed the world economy as a whole, slid into a deep recession, reaching an equilibrium characterised by low output, underused productive capacity and high unemployment. The practical implication of the Keynesian analysis was that governments should direct their attention to stimulating demand for output, rather than attempting to boost employment via wage reductions. From the Keynes perspective cutting wages would, by further reducing incomes and spending, make the situation worse rather than better.

The "classical" theory of unemployment

In explaining general unemployment as being due to deficiency of demand Keynes was adopting a theoretical position which was, at that time, "revolutionary". In the dim and distant past, in the earlier days of industrialisation, observers of the economic scene such as the Rev Thomas Malthus, the Rev Thomas Chalmers, the Swiss thinker, J C L Sismondi, and indeed Karl Marx, had taken a similar view and had worried about the possibility of maintaining an overall balance between the ever-growing capacity of the economy *to produce* and the supporting demand of the community *to purchase* goods and services, raising the possibility of unemployment occurring if the desire to buy fell short of the system's ability to produce. But, long before Keynes's time, such fears had been dismissed by orthodox economic opinion as groundless; conventional wisdom came to believe that a general want of demand for output relative to productive capacity (except perhaps very temporarily on the occasion of a commercial crisis) was an impossibility. The observed unemployment of the inter-war years was interpreted as the consequence of excessive wages – of workers pricing themselves out of employment by demanding wages higher than could be afforded by employers. In fact, just prior to the publication of Keynes's *General Theory*, the eminent English economist Professor A. C. Pigou had expounded in his *Theory of Unemployment* (1933) the conventional (what Keynes called "classical") view that the problem was one of too high wages. He wrote:

> "Since the post-Armistice boom, however, the unemployment situation has been very different from what it was before the war. Instead of a percentage of unemployment amounting to an average over good and bad years, to around 41/2 per cent. post-war unemployment has moved around a mean from twice to three times as large as this. This circumstance suggests strongly that the goal of long-run tendencies in recent times has been a wage

> substantially above that proper to nil unemployment, and that a substantial part of post-war unemployment is attributable to that fact" (Pigou, 1933).

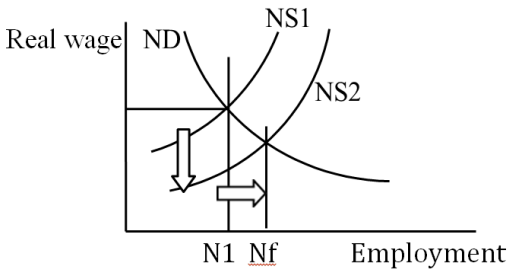
Pigou held that a reduction in money and (correspondingly, he believed) real wages would give a powerful boost to employment. His conception of unemployment was as "voluntary" – "voluntary" in the sense that the remedy for the situation lay in the hands of the workforce. This thesis Keynes attacked and (at least for some decades) succeeded in thrusting from the stage.

The labour market (neoclassical account)

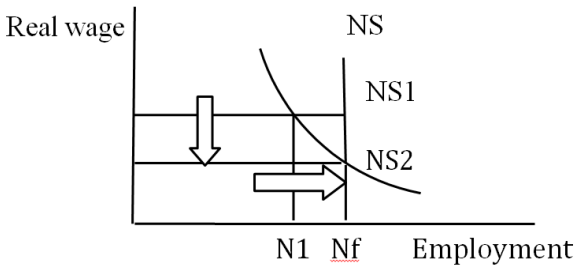
The conventional (to Keynes, "classical" or as we would today call it "neoclassical") theory is illustrated in Figure 1(a). Note that neoclassical theorists modelled the labour market exactly in the same way as they would any market for a final consumption good: equilibrium is established at the point of intersection of the demand and supply curves, demand and supply each being a function of price (in this instance the real wage). ND is the neoclassical (so-called) labour demand curve. NS is the usual, upward-sloping, labour supply curve. Pigou himself [Fig. 1(b)], perhaps more realistically, assumed the NS curve to be of a reverse-L shape, horizontal up to full employment.[3]) In the situation depicted in Figs.1(a) and 1(b) unemployment exists, for the reason that the labour supply curve (NS1) happens to be set "too high" to allow full employment. It is presumed that an appropriate change in the conditions of labour supply (shifting from position NS1 to NS2) would cause employment to increase to the full employment level (Nf).

Figure 1 Neoclassical representations of the labour market

(1a) The standard model



1(b) Pigou's model



Consider this story more closely. It is supposed that when unemployment exists, if a lower rate of wages were to be accepted, more labour would naturally be employed – on the tacit assumption that the extra output thereby produced is guaranteed a market. That is to say, underlying the conventional analysis of wages and employment is a Say's Law presumption that intended aggregate demand for output can be expected to match the volume of output offered for sale on the market; in other words that, as demand for output is "tame", there is no need to worry about demand for the extra output produced.

[3] A.C.P. confirmed in a note to J.M.K. (May 1937) that he envisaged the labour supply curve as right-angled with a reverse L-shape – the position of the vertical section indicating the number of "would-be wage earners" and the height of the horizontal section indicating the wage for which labour "stipulates" (Keynes, 1973, p.54).

It is important to recognise that there is something missing from this conventional representation of the labour market: the fact is that there is nothing in the standard diagram [Figure 1(a)] to show how demand for labour – as *derived* demand – may be affected by a change in demand for output. The so-called demand for labour curve – the downward-sloping (aggregate) marginal product of labour function – is in the short term fixed in position by the given conditions of technology: it cannot shift with changes in planned demand for output. That curve simply shows how the marginal productivity (by the neoclassical theory, the real wage) of labour varies with employment – whatever the level of employment may be. By contrast, in the short-term the labour supply curve alone can move (corresponding to changes in the terms on which labour is willing to work). Therefore, when utilising this diagram, the only feasible way of accounting for short term changes in the equilibrium level of employment is via shifts of the labour supply curve – *which is exactly how present day neoclassical theory explains changes in employment.*

All the familiar stories relying on misperceptions about the real value of money wages, on stickiness or on rigidity of money wages (as underlie the supply side of the commonly employed AD/AS analysis) explain changes in employment which follow from changes in expenditure as being due to shifts in the *real* terms on which labour is available for employment. (Figures 1(a) and 1(b)] That is to say, with respect to the neoclassical labour market diagram, the labour supply curve is understood to move relative to the demand for labour, thus altering the point of intersection of the two curves and implying a change in the level of employment. Unemployment emerging in such circumstances is what Keynes described as "voluntary" – and, unlike involuntary unemployment, is remediable by real wage adjustment.

What is wrong with the standard neoclassical labour market diagram is that the marginal product of labour schedule is incorrectly labelled as the "labour demand curve". That description ignores the fact that whatever the marginal product of labour may be, it cannot be profitable to employ and pay labour according to the notional value of its marginal product *if that product cannot actually find a market*. If we maintain, neoclassical fashion, the idea of diminishing marginal returns to labour in the short run, the reality (the satisfaction of this condition taken for granted by the conventional theory) is that if employment is to increase, it is necessary not only that the going wage falls as the marginal product of labour diminishes, but it is essential also that any increase in employment offered must be accompanied by a sufficient increase in demand for output to justify that extra employment.

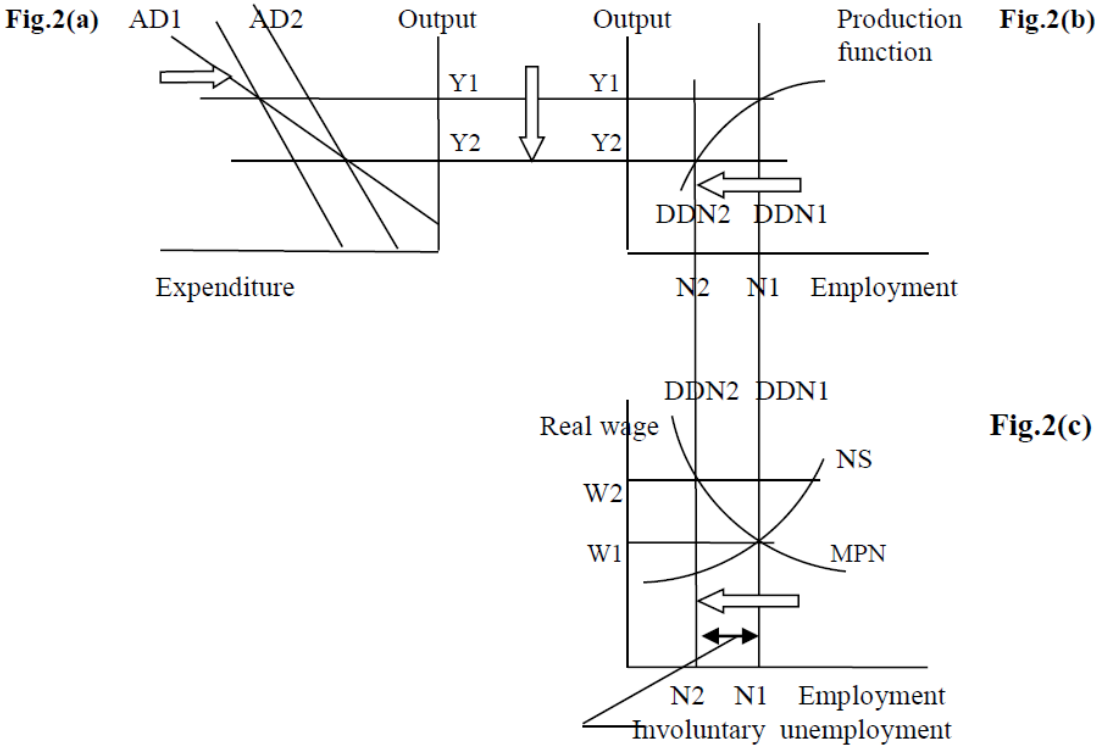
If demand for output, and so for labour, increases or decreases, firms will move to the right or left along their short-run supply curves, with the marginal product of labour decreasing or increasing accordingly. In other words, with respect to the labour market diagram, the MPN curve should be read as a *real wage function*, showing how the marginal product of labour varies with employment – as employment (the dependent variable) varies according to changes in the demand for output. The proper designation of the MPN schedule in this context is therefore as a "real wage schedule showing real wages as a function of the level of employment not vice versa." But the MPN schedule itself cannot tell us – even if the conditions of labour supply are known - what the demand-determined volume of employment actually is.

The labour market: Keynes's vision (1936)

The essential novelty of Keynes's theory of employment is that he identified demand for output as the key factor determining employment. From the Keynes perspective, employment is, *ceteris paribus*, determined by conditions *outside* the labour market – as we have already mentioned - by the state of demand for output in the product markets. If, as Keynes believed, aggregate demand for output, in a world of uncertainty, depends on unstable expectations, hopes and fears, concerning an unknown future, the level of employment within the economy is liable to be affected by swings in expectations and business confidence. Persisting pessimism amongst businessmen implies persisting slump conditions: the labour market is then characterised by an excess supply of labour relative to demand – involuntary unemployment. How do we relate that understanding to the conventional model of the labour market?

As demand for labour depends crucially on conditions beyond the labour market, on the state of expected demand for output, we may, in order to depict the impact of demand for output on the labour market, impose on the conventional labour market diagram a vertical line indicating how much labour (corresponding to demand for output) is actually required in the labour market. This link between **the** markets we call the "derived demand for labour function" (DDN); see Figure 2. The DDN function shows how demand for labour in the labour market [see 2c)] derives initially from the demand for output in the products market, via the going conditions of production [see 2(a) and 2(b)].

Figure 2 The derived demand for labour function (DDN) and involuntary unemployment



If we trace through the sequence of events depicted by this three-part diagram, the nature of Keynes's involuntary unemployment as demand-deficient employment should become clear. We consider first Keynes's 1936 account as presented in the *General Theory*. We then describe the simplified, but in basic principle *identical*, account advanced by Keynes in 1939. Consider the analysis of the *General Theory*. Start with the 45 degree line ("Keynesian cross") diagram in figure 2(a). We suppose that initially the aggregate demand function (AD1) lies in a position corresponding to full employment (income and output equal to Y1). The position of the "derived demand for labour" curve (DDN1) in diagrams 2(b) and 2(c) indicates, via the production function, that that level of output requires for its production the volume of employment N1 (corresponding to full employment) in the labour market.

Now suppose a fall occurs in aggregate demand, from AD1 to AD2. In response, with unsold inventories piling up, firms cut production and employment, so that output falls to Y2 and employment to N2. DDN shifts to position DDN2. In the labour market a gap emerges (N1 – N2) indicating the extent to which the contraction of final demand for output has brought about a decline in the demand for labour. (Note that equilibrium in the labour market is no longer established at the point of intersection of the MPN and labour supply curves.) This gap illustrates the presence of *demand-deficient* unemployment. It is also *involuntary* unemployment in that workers hitherto in employment have lost their jobs through no action or fault of their own. There has occurred no change either in the technological conditions of production and employment, nor in the terms on which labour is seeking employment: all that has happened is that conditions in the output markets have deteriorated, so that only a proportion of the previous volume of output can be sold.

But what about wages? If demand for labour has fallen and unemployment has emerged, the above model shows that real wages will have risen (W1 to W2). But Keynes in the *General Theory* makes the emphatic point that any such increase in real wages is the *consequence*, not the *cause*, of the rise in unemployment. What has happened is that, with demand for output falling firms have moved down their short run supply curves reducing employment (DDN moves to position DDN2) and implying, even with no alteration of money wages, a fall in commodity prices – and so some fall in the cost of living. In the face of falling demand, the workforce has certainly not pushed for an increase in *money* wages. The rise in real wages is simply an *incidental result* of the fall in demand for output, contraction of production and falling commodity prices; it is *not* the causative factor responsible for the fall inemployment.

Consider the opposite case – of a rise in aggregate demand - from AD2 to AD1. Output and employment increase, back, say, to Y1. DDN shifts from DDN2 to DDN1 and employment from N2 to N1. As output and employment rise, so does the cost of living, with prices rising (slightly) against unchanging money wages. Thus, real wages fall *permitting* movement down the MPN function, but that movement is initiated by, and occurs only with the rightward movement of the DDN curve. What do we make of this fact that real wages have fallen (W2 to W1)? Again, as in the equivalent case of a decrease in output and employment, the change in wages is the consequence, not the cause of the change in demand and employment. Such a reduction in real wages would not, *of itself*, have boosted demand to the full employment level. Keynes's reasoning here was that, when employment is increasing, even if the cost of living is rising a little, workers will not risk missing out on increased employment by insisting on higher money wages. In the *General Theory* Keynes put it thus:

> "[I]t is fortunate that the workers, though unconsciously, are instinctively more reasonable economists than the classical school, inasmuch as the resist

> reductions of money-wages, which are seldom or never of an all-round character, even though the existing real equivalent of these wages exceeds the marginal disutility of the existing employment; whereas they do not resist reductions of real wages, which are associated with increases in aggregate employment and leave relative money-wages unchanged, unless the reduction proceeds so far as to threaten a reduction of the real wage below the marginal disutility of the existing volume of employment. Every trade union will put up some resistance to a cut in money-wages, however small. But since no trade union would dream of striking on every occasion of a rise in the cost of living, they do not raise the obstacle to any increase in aggregate employment which is attributed to them by the classical school" (pp.14-15).

In other words, it was Keynes's opinion in 1936 that if, with changes in aggregate demand, commodity prices alter relative to money wages, such increases or decreases in the price level, and so in real wages, while facilitating adjustment (expansion of employment) in the labour market, are not the operative cause of recovery. Note also that Keynes supposes that, even if *money* wages are sticky, *real* wages – over the relevant range - are not; they adjust as required allowing employers to respond to increases in demand for output by increasing the volume of employment offered. It was therefore reasonable, he believed, *to link changes in demand for output directly with changes in the demand for labour and with employment*, without any intervening complications on account of these real wage changes. (That of, course, is what is illustrated by the DDN, derived demand for labour curve, we have introduced.)

The message, therefore, of the *General Theory*, in a nutshell, is this: because demand for labour is derived demand depending on expected demand for output, fluctuations in effective demand for output give rise to corresponding fluctuations in the demand for labour. Demand for labour can (and does) vary relative to the given quantity of labour seeking employment. Unemployment so caused may be described as "demand-deficient" or "involuntary" unemployment. Under conditions of deficient demand for output, there is little possibility of the workforce being able to remedy the situation through their own efforts. Demand for output is what matters. If it were possible to reduce real wages (to a greater extent than required to accommodate a given increase of demand) that would actually tend to diminish effective demand, both directly via reduced consumption, and indirectly, thereby worsening rather than improving the employment situation. Likewise money wage reductions, leading to price reductions and general deflation, would also be more likely to damage rather than stimulate effective demand: negative wealth effects from the increasing real burden of debt, combined with destabilising expectations of continuing deflation might very well outweigh any notional positive real balance effect.[4]

At this stage in the discussion it is appropriate to note Keynes's own definition of involuntary unemployment:

[4] Note Patinkin (1959, pp.582-587) on the unreliability of deflation as a means of stimulating effective demand: "The economic adjustment process of the market is too unreliable to serve as the practical basis of a full-employment policy. In other words, though the real balance effect must be taken into account in our theoretical analysis, it is too weak – and, in some cases (due to adverse expectations) too perverse - to fulfil a significant role in our policy considerations."

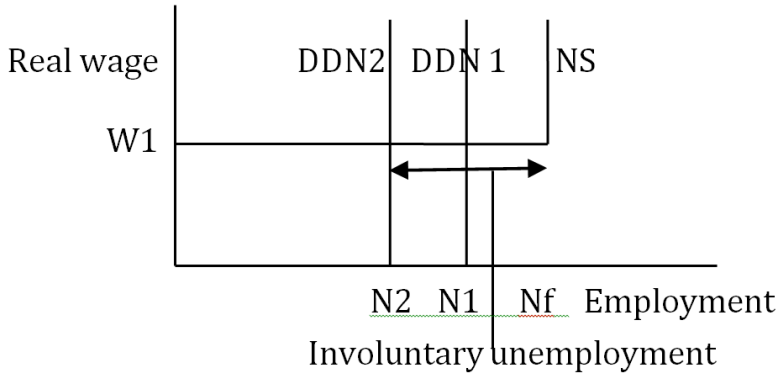
> "Men are involuntarily unemployed if, in the event of a small rise in the price of wage- goods relative to the money-wage, both the aggregate supply of labour willing to work for the current money-wage and the aggregate demand for it at that wage would be greater than the existing volume of employment" (Keynes, 1936, p.15).

On the basis of our discussion so far we can appreciate that Keynes is here proposing a thought experiment for the identification of involuntary unemployment. His point is that, if, starting with unemployment, in the event of increased spending and a small rise in the cost of living, more labour is willing to work, and becomes employed, than in the current situation, we observe that increased effective demand is bringing more people into employment. Alternatively, an increase in effective demand for output creates jobs for people hitherto without work but willing to work on terms consistent with their employment. In our Figure 2, a rightward shift of the DDN curve brings increased employment, with, at the same time, some rise in the cost of living (which, in the circumstances, is not resisted by the workforce).

Keynes's simplification (1939)

We have, however, not quite completed our exposition of Keynes's theory of effective demand and involuntary unemployment. What remains to be noticed is that, shortly after publication of the *General Theory* Keynes (1939) simplified the somewhat complicated story offered in the *General Theory* regarding wages and employment. On the basis of newly-gathered evidence (Dunlop, 1938 and Tarshis, 1939) he concluded that in reality (contrary to the standard neoclassical prediction) real wages did *not* fall as employment increased. In fact, on the evidence, no systematic short-term relationship appeared to exist between employment and real wages. Keynes decided therefore that it was unnecessary to offer the rationale presented in the *General Theory* as to why workers would not resist small reductions in real wages when employment was rising, meaning that, in the short run, output and employment could be understood to increase or decrease without any accompanying changes in real wages occurring. (See Figure 3).

Figure 3 A representation of Keynes's 1939 model of the labour market



From this representation of the labour market, which no longer involves a downward-sloping MPN function, it is clearly seen that the going level of employment, and demand-led changes

in employment, are determined without reference to the current rate of real wages. Aggregate demand for output and employment vary together without any change in wages being implied. Involuntary unemployment is unambiguously attributable to want of demand for output.

Figure 3 presents essentially the same understanding as does Figure 2 of how the situation in the labour market depends on the state of demand in the product markets. (Note we have borrowed the Pigouian reverse L-shaped labour supply curve.) The labour supply curve (NS) shows how much labour is available at the going (real) wage W1. It is understood that that wage corresponds to the (invariant) marginal value placed by employers on all labour available for employment (maximum labour supply, Nf). The vertical lines DDN1 and DDN2 show the derived demand for labour according to the levels of aggregate demand for output. The quantity of employment offered is determined at the point of intersection of the relevant DDN curve with the labour supply function. DDN moves rightwards or leftwards according to whether aggregate demand for output is rising or falling; the wage rate remains constant at W1. Any gap which exists between the equilibrium level of employment thus indicated and the level of full employment (Nf) represents demand-deficient unemployment, which, by its nature, is involuntary unemployment.

Other categories of unemployment

We should note here that a distinction may be drawn between involuntary and other – "frictional" and "structural" – types of unemployment. The former of these refers to the normal turnover of people who – for whatever reason – are temporarily between jobs; the latter denotes more difficult conditions due to a changing industrial structure, when workers redundant in a declining sector may not find it easy to secure employment in an expanding one. While not denying that these types of unemployment may well involve a painful involuntary element and do require remedial action, we distinguish these long-understood categories of unemployment from Keynes's demand deficient involuntary unemployment for the reason that these are problems best dealt with by policies other than those needed to cope with a general, economy-wide deficiency of demand.

Note also that it has been suggested that certain other theoretical models also describe situations of involuntary unemployment: "implicit contract theory" (Azariadis, 1975), "staggered wage setting" (Taylor, 1979) and "efficiency wages" (Shapiro and Stiglitz, 1984) have been mentioned in this context. But in so far as these involve price stickiness and artificially increased wages they do not seem to fall within the scope of Keynes's own definition of involuntary unemployment.

New Classical Macroeconomics: denial of involuntary unemployment

For 30 or so years after the publication of the *General Theory*, Keynes's understanding of the working of the macroeconomy essentially constituted the basis of a "Keynesian" orthodoxy, with involuntary unemployment understood as the consequence of deficient demand. But from the late 1960s or early 1970s, old ideas began to return to fashion, with a pre-Keynesian emphasis on conditions of labour supply as responsible for unemployment. What is known as the "New Classical Macroeconomics" has come to play a prominent role in current theoretical discussion. The theories advanced by this school of thought with respect to unemployment and the working of the labour market essentially represent a rehabilitation of the old classical

approach of Professor Pigou in that the focus is again on *conditions of labour supply* as critical to explaining what is happening to employment. From this perspective there is no such thing as involuntary unemployment, with labour's desire to work frustrated by a dearth of employment opportunities.

This New Classical analysis first appeared (Friedman, 1968; 1975; Phelps, 1975) in the context of attempts to prove that it is impossible, through macroeconomic management, to maintain over time a level of employment in excess of the so-called "natural rate of unemployment." The argument was that while, initially, as implied by the Phillips Curve, a higher level of demand could be bought at the price of a somewhat higher rate of inflation, in the longer term no such trade-off was possible as the "unnaturally" high level of activity could only be sustained by constantly increasing the rate of inflation. This scenario was derived via a return to the old classical model of the labour market, with employment determined at the intersection of the labour demand and supply curves, both labour demand and labour supply being taken as functions of the real wage. This analysis soon found its way into general use in macroeconomic theory. We can say that, with its introduction as a key element of the popular AD/AS macroeconomic model, the New Classical theory of the working of the labour market has become a well-established part of mainstream macroeconomics.

Consider how the system is supposed to operate. Starting from a situation of in the labour market of equilibrium at the natural rate (full employment), suppose a change in spending on goods and services – say, an increase in aggregate demand. According to the New Classical theory (which characteristically focuses on the efficacy of the price mechanism in a world without uncertainty) the sequence of events is as follows. An increase in spending causes commodity prices to rise: in the labour market the VMP (value marginal product) curve rises against the labour supply curve. Money wages increase and workers – not anticipating or perceiving a corresponding increase in commodity prices – misinterpret the increase in money wages for a sustained increase in real wages: the supply of labour therefore increases and employment rises. But once the workforce appreciates that goods prices have also risen, labour supply would return to its original level were it not that, with employment still in excess of the natural rate, money prices (and so money wages) continue to rise. This process of wage and price inflation, with wages playing catch-up on prices, continues until prices and wages have risen equi-proportionately; at which point the real wage has returned to its equilibrium value and employment is back at the natural rate. All the time, throughout this process of change, employment adjusts to accord with the wishes (even if ill-informed) of the workforce. An equivalent story could be told of the short-term and longer-term consequences of a decrease in aggregate spending on output: output and employment would fall below the natural rate as labour was withdrawn from employment on the "misperception" that real wages were falling, and employment would in time increase as, through the adjustment process, perceived real wages are restored to their "natural" value.

Note what this New Classical story implies. Output changes in response to changes in demand because, via the effects of these spending changes on commodity prices and thus on (perceived) real wages, employment is understood to rise or fall, thereby permitting output to change. From the point of view of labour, these changes in employment are voluntary: for instance, when employment is relatively low workers do not consider they have been forced out of work, rather their situation is that, in the circumstances, they prefer leisure to work. This is certainly not a situation of involuntary unemployment; labour is never "off its supply curve." We may add that, according to the New Classical theory, not only is this "unemployment" voluntary – it is also temporary and self-correcting: as, in time, with the confusion about the

real reward for working eliminated, employment returns to its normal (equilibrium) level. All in all, from this perspective, the effects of a downturn in aggregate demand for output do not seem to matter nearly as much as they do from the Keynesian viewpoint. As a recent critic asked, "do New Classical theorists really believe that in the years of the Great Depression, workers had simply chosen to enjoy a particularly long holiday?"

While the above "misperceptions" explanation of unemployment as resulting (temporarily) from changes in demand for output seems well embedded in present day mainstream macro theory, another strand of New Classical thought (but rather more on the fringe of the mainstream), the "Real Business Cycle Theory" (Stadler, 1994) likewise proposes that fluctuations in employment be read as corresponding to voluntary changes in the supply of labour offered for employment. This line of thought links changes in labour supply with changes in technology which are said to cause increases or decreases in the marginal product of labour, and so in the wages offered to workers. The theory is that workers will choose to work more (offer more labour), earn high wages and save in times of high productivity, in order to finance leisure from work at times of low productivity and low earnings. This appears to be a theory of the variations in the number of employed which, over time, constitutes "full employment." Perhaps, not surprisingly, the RBC theory remains a minority taste – one reason (not to mention doubts about the behaviour predicted) being that its proponents have found difficulty in identifying the technological changes said to engender the behaviour in question.

Conclusions

Within economics views differ on the subject of involuntary unemployment. The Keynesian side of the profession has no doubts that the concept is a realistic and relevant one, recognising involuntary unemployment as a damaging economic phenomenon which imposes high costs on society. Mancur Olsen (1982) condemned economists "who denied the concept of involuntary unemployment and put their theories ahead of 'common sense and the observations and experiences of literally hundreds of millions of people.'"[5] On the other hand some economists refuse to admit that such a phenomenon exists. Lucas (1978) claimed that "an unemployed worker at any time can always find a job at once."[6] The truth of that statement may be doubted, and even in the fortunate event of a marginally less unpalatable option – such as selling the *Big Issue* being available – that may properly be regarded not so much as a proper job, more of a desperate emergency measure.[7]

Although the idea of involuntary unemployment has largely disappeared from mainstream macroeconomics, that does not mean that the problem has disappeared from the real world; rather it points to the fact that much modern macrotheory, in assuming that agents possess virtually full knowledge of the future, and in losing sight of Keynes's penetrating understanding of the working of the macro economy, has altogether cut itself off from any hope of understanding fluctuations in economic activity and the causes of unemployment in the real world.

[5] Olsen (1982) observation quoted from Wikipedia entry on "Involuntary Unemployment".
[6] Likewise the Lucas (1978) quotation.
[7] Compare Joan Robinson (1936) on "disguised unemployment".

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