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Unemployment Policy

By ROBERT E. LUCAS, JR.*

The *U.S.* unemployment rate was certainly too high in 1975, and most economists would agree that it is too high today. It will also be agreed that this observation poses a problem for public policy (in a sense that the observation that winters in Chicago are "too cold" does not). But what exactly is meant by the statement that unemployment is "too high," and what is the nature of the policy problem it poses? This question can be answered in more than one way, and the answer one chooses matters a great deal.

One common answer to this question is that there exists a rate of unemployment—call it "full employment"—which can and should serve as a "target" for economic policy. Unemployment above this rate is regarded as being of a different character from the "frictional" unemployment required to match workers and jobs efficiently, and is treated from a welfare point of view as waste, or deadweight loss. Elimination of this waste is an objective of monetary, fiscal, and perhaps other policies. In the first part of this paper, I will argue that this way of posing the issue does not lead to an operational basis for unemployment policy, mainly on the ground that economists have no coherent idea as to what full employment means or how it can be measured.

An alternative view, prevalent prior to the Great Depression and enjoying something of a revival today, treats *fluctuations* in unemployment and other variables as posing a policy problem. On this view, the average (or natural, or equilibrium) rate of unemployment is viewed as raising policy issues only insofar as it can be shown to be "distorted" in an undesirable way by taxes, external effects, and so on. Nine percent unemployment is then viewed as too high in the same sense that 2 percent is viewed as "too low": both are symptoms of costly and preventable instability in general economic activity. In the concluding part of this paper, I will sketch the approaches to unemployment policy which are suggested by this alternative view and some which are not.

I. Full Employment: Definition and Measurement

The idea that policy can and should be directed at the attainment of a particular, specifiable *level* of the measured rate of unemployment (as opposed to mitigating *fluctuations* in unemployment) owes it wide acceptance to John Maynard Keynes' *General Theory*. It is there derived from the prior hypothesis that measured unemployment can be decomposed into two distinct components: "voluntary" (or frictional) and "involuntary," with full employment then identified as the level prevailing when involuntary unemployment equals zero. It seems appropriate, then, to begin by reviewing Keynes' reasons for introducing this distinction in the first place.

Keynes (ch. 2, p. 7) classifies the factors affecting equilibrium employment in a real general equilibrium theory: the mechanics of matching workers to jobs, household labor-leisure preferences, technology, and the composition of product demand. Is it the case, he asks, that spontaneous shifts in any of these four real factors can account for employment fluctuations of the magnitude we observe? Evidently, the answer is negative. It follows that two kinds of theory must be needed to account for observed unemployment movements: granted that real general equilibrium theory may account for a relatively constant, positive component, *some other theory* is needed for the rest.

*University of Chicago. I am very grateful for criticism of an earlier draft by Jacob Frenkel, Sherwin Rosen, and Jose Scheinkman.

Accepting the necessity of a distinction between explanations for normal and cyclical unemployment does not, however, compel one to identify the first as voluntary and the second as involuntary, as Keynes goes on to do. This terminology suggests that the key to the distinction lies in some difference in the way two different types of unemployment are *perceived by workers*. Now in the first place, the distinction we are after concerns *sources* of unemployment, not differentiated types. One may, for example, seek very different theoretical explanations for the average price of a commodity and for its day-to-day fluctuations, without postulating two types of price for the same good. Similarly, one may classify motives for holding money without imagining that anyone can subdivide his own cash holdings into "transactions balances," "precautionary balances," and so forth. The recognition that one needs to distinguish among sources of unemployment does not in any way imply that one needs to distinguish among types.

Nor is there any evident reason why one would *want* to draw this distinction. Certainly the more one thinks about the decision problem facing individual workers and firms the less sense this distinction makes. The worker who loses a good job in prosperous times does not *volunteer* to be in this situation: he has suffered a capital loss.[1] Similarly, the firm which loses an experienced employee in depressed times suffers an undesired capital loss. Nevertheless the unemployed worker at any time can always find *some* job at once, and a firm can always fill a vacancy instantaneously. That neither typically does so *by choice* is not difficult to understand given the quality of the jobs and the employees which are easiest to find. Thus there is an involuntary element in *all* unemployment, in the sense that no one chooses bad luck over good; there is also a voluntary element in all unemployment, in the sense that however miserable one's current work options, one can always choose to accept them.[2]

Keynes, in chapter 2, deals with the situation facing an *individual* unemployed worker by evasion and wordplay only. Sentences like "more labor would, as a rule, be forthcoming at the existing money wage if it were demanded" are used again and again as though, from the point of view of a jobless worker, it is unambiguous what is meant by "*the* existing money wage." Unless we define an individual's wage rate as the price someone else is willing to pay him for his labor (in which case Keynes' assertion above is *defined* to be false), what *is* it? The wage at which he would *like* to work more hours? Then it is *true* by definition and equally empty. The fact is, I think, that Keynes wanted to get labor markets out of the way in chapter 2 so that he could get on to the demand theory which really interested him. This is surely understandable, but what is the excuse for letting his carelessly drawn distinction between voluntary and involuntary unemployment dominate aggregative thinking on labor markets for the forty years following?

It is, to be sure, possible to write down theoretical models in which households are faced with an "hours constraint" limiting the hours they can supply at "the" prevailing wage, and in which, therefore, there is a clear distinction between the hours one can supply and the hours one would like to supply. Such an exercise is frequently motivated as an attempt to "explain involuntary (or Keynesian) unemployment." This misses the point: involuntary unemployment is not a fact or a phenomenon which it is the task of theorists to explain. It is, on the contrary, a theoretical construct which Keynes introduced in the hope that it would be helpful in discovering a correct explanation for a genuine phenomenon: large-scale fluctuations in measured, total unemploy-

[1]Given the time-consuming nature of job search and the element of luck involved in finding a good "match," there is a capital-like element in most jobs. With job-specific human capital, the capital loss involved in job (or employee) loss is increased.

[2]These observations refer to easily verified features of any sizable labor market. Aggregate statistics on unemployment or on listed vacancies do not bear on their accuracy, since listing oneself as unemployed does not imply that one would accept *any* employment, nor is an advertised vacancy available to *any* job applicant.

ment. Is it the task of modern theoretical economics to "explain" the theoretical constructs of our predecessors, whether or not they have proved fruitful? I hope not, for a surer route to sterility could scarcely be imagined.

In summary, it does not appear possible, even in principle, to classify individual unemployed people as either voluntarily or involuntarily unemployed depending on the characteristics of the decision problems they face. One cannot, even conceptually, arrive at a usable definition of full employment as a state in which no involuntary unemployment exists.

In practice, I think this fact has been recognized for some time. Estimates of full employment actually in use have been obtained using aggregate information rather than data on individuals. As recently as the 1960's it was widely believed that there was some level of aggregate unemployment with the property that when unemployment exceeded this rate, expansionary monetary and fiscal measures would be noninflationary, while at rates below this critical level they would lead to inflation. One could then identify unemployment rates at or below this full-employment level as frictional or voluntary, and unemployment in excess of this level as involuntary. It was understood that only unemployment of the latter type posed a problem curable by monetary or fiscal policy. As Walter Heller wrote, "Gone is the countercyclical syndrome of the 1950's. Policy now centers on gap closing and growth, on realizing and enlarging the economy's non-inflationary potential" (Preface). Later, Heller refers to "the operational concepts of the 'production gap,' 'full-employment surplus,' the 'fiscal drag,' and 'fiscal dividends'" (p. 18).

For the purpose of calculating the production gap to which Heller referred, it makes little difference whether the voluntary-involuntary terminology accurately reflects differences in the way unemployed people view their situations. The issue here is rather whether there exists an aggregate rate of unemployment (on the order of 4 or 5 percent) which is of use in measuring an economy's noninflationary potential. If there were, then objections of the sort I have raised above could be dismissed as merely terminological: if one objected to calling unemployment above the designated full-employment level involuntary, one could call it something else, perhaps wasteful or unnecessary.

The last ten years have taught us a great deal about this operational concept of a production gap. In 1975, the *U.S.* economy attained the combination of 9 percent inflation and an unemployment rate of 9 percent. Applying the concept of a production gap to these numbers, does one conclude that the noninflationary potential of the *U.S.* economy is associated with unemployment rates in excess of 9 percent? Does one redefine 9 percent inflation to be noninflationary? Or can the entire episode be somehow pinned on oil prices?

I have reviewed two possible routes by which one might hope to give the term full employment some operational significance. One was to begin at the individual worker level, classifying unemployment into two types, voluntary and involuntary, count up the number classed as voluntary, and define the total to be the unemployment level associated with full employment. A second was to determine the operating characteristics of the economy at different rates of unemployment, and then to define full employment to be the rate at which inflation rates are acceptable. Neither of these approaches leads to an operational definition of full employment. Neither yields a coherent view as to why unemployment is a problem, or as to the costs and benefits involved in economic policies which affect unemployment rates. The difficulties are not the measurement error problems which necessarily arise in applied economics. They arise because the "thing" to be measured does not exist.

II. Beyond Full-Employment Policy

Abandoning the constraint that any discussion of unemployment must begin first by drawing the voluntary-involuntary distinction and then thinking in separate ways about these two types of unemployment will, I think, benefit both positive and normative analysis. Practicing social science is hard enough without crippling oneself with dogmatic constraints. A terminology which precludes asking the question: "Why do people choose to take the actions we see them taking, instead of other actions they might take instead?" precludes any serious thinking about behavior at all.

Whether or not the body of work stemming from the Edmund Phelps volume, and earlier work of George Stigler, John McCall and others, has produced all the right answers about the determinants of employment and unemployment, it has at least begun to pose some of the right questions. By treating all unemployment as voluntary, this work has led to the examination of alternative arrangements which firms and employees might choose to adopt for dealing with fluctuations in product demand, and their reasons for choosing to react to such fluctuations in the way we observe them doing. Pursuit of this question has indicated both how very difficult it is, and even more so how much economics was swept under the rug by "explaining involuntary unemployment" by incompetent auctioneers or purely mechanical wage and price equations.

Practicing normative macroeconomics without the construct of full employment does take some getting used to. One finds oneself slipping into such sentences as: "There is no such thing as full employment, but I can tell you how it can be attained." But there are some immediate benefits. First, one dispenses with that entire meaningless vocabulary associated with full employment, phrases like potential output, full capacity, slack, and so on, which suggested that there was some *technical* reason why we couldn't all return to the 1890 workweek and produce half again the *GNP* we now produce. Second, one finds to one's relief that treating unemployment as a voluntary response to an unwelcome situation does not commit oneself to normative nonsense like blaming depressions on lazy workers.

The effect it does have on normative discussion is twofold. First, it focuses discussion of monetary and fiscal policy on *stabilization*, on the pursuit of price stability and on minimizing the disruptive effects of erratic policy changes. Some average unemployment rate would, of course, emerge from such a policy but as a by-product, not as a preselected target. Second, by thinking of this natural rate as an equilibrium emerging from voluntary exchange in the usual sense, one can subject it to the scrutiny of modern methods of public finance.

To take one example, as the level of unemployment compensation is varied, an entire range of average unemployment rates, all equally "natural," is available to society. At one extreme, severe penalties to declaring oneself unemployed could reduce unemployment rates to any desired level. Such a policy would result in serious real output losses, as workers retain poor jobs too long and accept poor jobs too readily. An output-maximizing unemployment compensation scheme would, with risk-averse workers, involve a subsidy to being unemployed, else workers retain a poor but relatively sure current wage in preference to the riskier but, on average, more productive return to seeking a new job. In view of the private market's inability to provide sufficient insurance against unemployment risk, still further gains in expected utility could be expected by still higher unemployment compensation, resulting in a deliberate sacrifice in real output in exchange for a preferred arrangement for allocating risk.[3] Notice that as one traces out tradeoffs of this sort, the issue of slack or waste does not arise. Different policies result in different levels of real output, but output increases are necessarily obtained at the expense of

[3]See Kenneth Arrow's analysis of medical insurance.

something else. Whether any particular level of unemployment compensation is too high or too low is a difficult issue in practice, but it is one that cannot be resolved simply by observing that other, unemployment reducing, compensation levels are *feasible*.

The policy problem of reducing business cycle risk is a very real and important one, and one which I believe monetary and fiscal policies directed at price stability would go a long way toward achieving. The problem of finding arrangements for allocating unemployment risks over individuals in a satisfactory way is also important, and can be analyzed by the methods of modern welfare economics. The pursuit of a full-employment target which no can measure or even define conceptually cannot be expected to contribute to the solution of either problem.

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