

How Does Unemployment Affect the Economy

Many of us know that unemployment rate is indicative of the state of the economy, but do you know how does it affect the economy? Here are the effects of unemployment on the economy, and when it is favorable.

It is bad news when the unemployment rate is high. It means that there are more candidates per job opportunity to compete against, which in turn implies that you have slimmer chances to get it. And we all know that you need to work to earn a living. But, not just for the unemployed, high unemployment is a matter of concern for everyone, even for the guy who has a job. All facets of the economy have a domino effect on each other. Nevertheless, changes in unemployment are of critical importance to the growth and prosperity of the economy.



Effects of Unemployment on the Economy

• Wealth drainage

When you are unemployed, the government provides monetary assistance which is partly untaxed. A high unemployment rate means it has to shell out more money from the budget to support a large number of unemployed people, creating heavy burden on the budget and cut-backs in other areas. Wealth is drained from the economy for unproductive purposes and economic growth slows down as there are fewer funds for infrastructural development. Also, employment creation for a high percentage of unemployed population becomes challenging.

• Slack in flow of money

Circular flow of income is the lifeline of a flourishing economy. Unemployment slows down this flow by the lack of money inflow and outflow. When money is not pumping in the economy, its growth becomes sluggish. An economy may show signs of jobless recovery with continual increase in the rate of unemployment. Such a growth may lead to a slow recovery from the recession in future, or may be an indicator of double-dip recession!

• Wage inflation

Due to increase in competition for jobs and wide availability of labor, the cost of labor decreases significantly. Those who are employed will be severely affected in case of rise in unemployment in the economy. Noticeably, reduction in wages and salary leads to decrease in the amount of tax collection on the income. This further hinders the scope of availability of sufficient funds to pump into the economy.

• Reduction in consumer expenditure

The unemployed are naturally trying to stretch their financial assets for a longer duration due to the uncertainty of the end of unemployment. This leads to reduction in consumer expenditure due to financial limitations and greatly affects the retail sector. Decrease in the volume of sales translates to reduction in output and subsequently profits for companies, prompting them to tone down their budgets, often by firing employees. In fact, unemployment benefits exceeding \$2,400 are taxable on federal return in later years once employment has been secured. This creates a liability in the future for the tax-payer, although the state reaps the returns on investment.

- **Under-utilization of resources**

High unemployment rate denotes wastage of labor productivity, under-utilization of the capacity of machinery and raw materials available to produce output supplied to match the reduction in demand for products and services. Negative growth in demand and supply leads to deflation in order to promote consumer expenditure.

- **Increase in debts**

Decrease in availability of funds with the government to invest in public spending, coupled with fall in revenue generated from tax collection, has a cumulative effect on the size of the fiscal budget available for social welfare. The government instinctively raises tax rates. Lesser capital flow in the economy encourages debts and borrowings that have to be paid along with interest. Since people are unemployed or earning lesser income, it becomes harder to repay debts. This increases mortgages on housing, instances of bankruptcy and deflation.

- **Decrease in return on investment**

Higher deficit in the current account is another outcome of high unemployment in the economy. Lack of federal spending due to unavailability of financial resources and devaluation of the currency propels feelings of ambiguity towards the future among investors. Fall in the net national income and investment induces decrease in ROI. Moreover, investors may even begin pulling out money from the economy to invest in promising industries belonging to other prosperous economies that are not struggling with high levels of unemployment.

The cumulative effect of the above is slack in the growth of the GDP of the economy and sometimes, even a negative growth may be observed. Such stagnation in economic growth may stimulate people to start independent businesses, thereupon, contributing to creation of job opportunities. If you must know, zero unemployment is also an undesired state for an economy. Especially for a capitalist economy, it is very important to maintain the optimum level of unemployment to maintain an equilibrium between the demand and supply of goods.

It can be said that the unemployment situation is a good lagging indicator of an economy's health. In fact, the effect of unemployment on an economy is of such significance that it even helps the government shape monetary and fiscal policies. However, it must be noted that even in the wake of recovery from recession, unemployment in an economy may continue to show steady growth due to companies' apprehensions towards the economic future. As of December 2011, the unemployment rate in the United States has shown a drop of 0.4% since last month and is currently at 8.6%, the lowest recorded unemployment rate this year, post the recession of 2007! This has turned out favorably following forecasts that suggested an expected decline of 0.5% to 1.5% in the subsequent year.

Read more at Buzzle: <http://www.buzzle.com/articles/how-does-unemployment-affect-the-economy.html>