Opportunity Cost of Unemployment

by

Young Back Choi*

*Department of Economics and Finance, St. John's University, 8000 Utopia Parkway, Jamaica, NY 11439. The paper is prepared for discussion at the Colloquium on Market Institutions and Economic Processes, Nov 9, 2009. I am grateful to Prof. Israel Kirzner for his comments on an earlier draft.

One of the main concerns of modern politics is unemployment. For politicians keeping the rate of unemployment at a low level is a matter of survival. The mantra of modern politicians, from the President of the United States down to the mayor of a small city or a county executive, is "to create good paying jobs." For the majority of economists, who share the concern, unemployment costs too much, (or unemployment is inefficient.) If some labor, willing and able to work, is not gainfully employed, then the proverbial economic pie is smaller than what it could be. The difference between the potential and the actual is the opportunity cost of unemployment.

In 2008 the US GDP was about $14.4 trillion and the unemployment rate, 6%. One may observe that had all the unemployed been employed, the GDP would have been about $920 billion larger.[1] In 2009 the US GDP is about $14.1 trillion and the unemployment rate, 9.8%. By the similar reasoning, the estimated opportunity cost of unemployment would be $1.36 trillion. Based this sort of considerations, one is bound to conclude that the opportunity cost of unemployment is significant indeed.

Of course, not everyone think that zero unemployment is even possible in a working economy; many economists believe that even a well functioning economy would have a certain level of unemployment, viz., the natural rate of unemployment. Accordingly, one may argue that only the unemployment rate above the natural rate of unemployment, say, 5%, should be counted as opportunity cost of unemployment.[2] In this case, the

[1] (14.4/0.94)-14.4=0.919.

[2] The widespread acceptance of the concept of natural rate of unemployment did not prevent many economists from complain about the "jobless recovery" in early 2002 as President Bush announced his intention to seek the second term. The unemployment rate stood at 4.2%.

opportunity cost of unemployment above the natural rate in 2008 would be about $153 billion. In 2009, it would about $700 billion. The cost is still not insignificant.[3]

Either way, the idea of the opportunity cost of unemployment seems to make sense. There is a seeming consensus among economists, as evidence by the majority of economic textbooks using the concept of the opportunity cost of unemployment as a justification for Macroeconomics and counter-cyclical economic policies.[4]

One cannot help but notice, however, that the idea of the opportunity cost of unemployment is a metaphor, an "as if" proposition. The concept of opportunity cost presumes an actor faced with alternatives among which he can choose. When the actor chooses to act in a certain way, the opportunity cost of his choice is the value of what he gives up by not acting some other way. When there is neither the actor, nor alternatives among which one can choose, the idea of opportunity cost makes no sense. Since the economy is not an actor, but a collection of independent actors, and the unemployment rate is a snapshot of the economy, whose pattern is an unintended consequence of myriad interactions among separate actors, not a choice variable the policy maker can pick at will, the idea of the opportunity cost of unemployment, strictly speaking, does not apply.

Only by analogy, the idea of opportunity cost of unemployment would make sense if one imagined that the economy as a whole is faced with alternative levels of unemployment among which it can choose. The analogy, which immediately conjures up

[3] One may make a passing remark that if one tries to approximate the opportunity cost of unemployment by multiplying the rate of unemployment by GDP, one would overstate it, given the fact that the rate of unemployment tends to be higher among lower paying jobs.

[4] A. Abel, B. Bernanke, and D. Croushore, Macroeconomics, 6th ed. Pearson Addison-Wesley, 2008, "[the opportunity cost of unemployment is] the loss of output that occurs because fewer people are productively employed…." 458. Many textbooks on macroeconomics express a similar view.

the image of a centrally planned economy, however, raises many questions about its usefulness for the market oriented economy.

In the remainder of the paper we will examine some of the problems that arise from applying the concept of opportunity cost to the whole economy, or its designated policy-maker, as if he or she is faced with genuine alternatives each representing different states of the whole economy. In this connection, we will consider jobs as value-creating process, the role of the entrepreneur in creating jobs, and the kind of jobs that government can create.

But let's first consider the problem of estimating the opportunity cost of unemployment, arising in part from the subjectivism of individual decision making and also from the difficulty of the Keynesian concept of involuntary unemployment.

II

One question that arises immediately with the idea of the opportunity cost of unemployment is whether its measurement is possible even conceptually. By the opportunity cost of unemployment economists usually have in mind the jobs that the unemployed could have had if they were employed, or rather foregone values (wages) associated with the putative jobs. But what jobs? Are these the jobs the unemployed had before they were laid-off? What about those who left jobs willingly (presumably for something better), or those who are new to the labor force? Or are these the jobs simply the unemployed wish they had? It seems that economists have not thought through the question of what jobs should be counted as the opportunity cost of unemployment.

To clarify the issue, we should think about at least three distinct classes of the unemployed: the laid-off, the quitter, and the entrant to the labor force, (either new or renewed).[5]

<u>The laid-off</u>: Most economists seem to have in mind the value of the jobs the laid-off had before their separation when they speak of the opportunity cost of unemployment. For the laid-off, however, keeping the job must not have been an option. Therefore, the associated wage income cannot be counted as the opportunity cost.

What then can be counted as the opportunity cost of unemployment for the laid-off? The alternative course of action for the laid-off is to look for another job or become self-employed, or retire, (which is a form of self-employment, as those who are not in the labor force are similarly "employed".) If the laid-off remains unemployed, it must be that he prefers the state of being unemployed (with a prospect of finding an agreeable job in the future) to other alternatives, including becoming self-employed or getting a job that is not suitable for him (in terms of wages, working conditions, location, etc.)[6] Suppose that the laid-off has not seen any meaningful job offer since his layoff.[7] In this case, the opportunity cost of unemployment for the laid-off unemployed who has not seen a job offer must be smaller than the value of the job from which he was laid-off.

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[5] Of about 7 million unemployed in the US in 2006, the composition is 47% job losers (the laid-off), 12% job leavers (or quitters in this paper), and 41% re-entrants or new entrants. The composition of job losers is 13% temporary layoff, 24% permanent job losers, and 10% completed temporary jobs. Of all the unemployed, 67% was unemployed less than 14 weeks, 37% being unemployed less than 5 weeks. 18% remained unemployed over 27 weeks. 56% of those on temporary layoff and 44% of job leavers stay unemployed less than 5 weeks. Source: *Annual Average Household Data. 29. Unemployed Persons by Reason for Unemployment, Sex, Age, and Duration of Unemployment*. www.bls.gov/cps/home.htm

[6] The majority of the laid-off may not view self-employment or retirement and urbanized) economy, relatively few have an aspiration or experience for self-employment. Therefore, these are viewed by many as poor alternatives, if at all. That is why they are often overlooked.

[7] It is entirely possible that the unemployed has not seen a job offer because he is only looking for certain kind of employment, ignoring a host of other possible jobs that one can have just for the asking. If so, the case is not unlike the case of someone remaining unemployed after turning down job offers, discussed below.

If the unemployed has an outstanding job offer and yet remains unemployed, then the opportunity cost of his unemployment could be as high as the value of the turned-down job offer. In this case, the state of being unemployed with a prospect of finding a more agreeable job in the future must be preferable over other alternatives such as the job offer refused, or self-employment. The opportunity cost of unemployment for the laid-off turning down a job offer is probably less than the value of the job from which he was laid-off.[8] The situation of the unemployed who turns down a job offer is akin to that of the quitter.

<u>The quitter</u>: The quitter includes both the formerly employed who quit the job and the formerly self-employed who quit the business. No matter what the reason is for quitting, the value of the job, or business, the unemployed has just quit *cannot* be more valuable than what he expects to get by quitting. No one chooses the worse over the better.

For the unemployed by reason of quitting, at the time of his quitting, the opportunity cost of unemployment is likely to be the value of the job he has quit. If the quitter remains unemployed, would his or her opportunity cost of unemployment remain the same? It would depend on whether or not the job he quit is still available to him. If the job he quit is still available, yet the quitter remains unemployed, it is like the unemployed keeps on turning down a job offer. The opportunity cost of unemployment is the value of the job he keeps on turning down.

If the job is no longer available to him, regrettably, his situation is exactly the same as the unemployed for the reason of being laid-off, (though in this case the layoff was self-orchestrated.) The value of the job he quit can no longer be counted as the

[8] In an unlikely event, the turned-down job offer could be higher than the job from which the unemployed had been laid-off.

opportunity cost of unemployment. The alternatives available to the unemployed depend on whether or not he is faced with a new job offer. Without a job offer, the opportunity cost of unemployment is the highest valued alternative available to him—either self-employment, or taking a job that he regards as unacceptable, or being unemployed with the prospect of finding a job closer to his liking.[9] The valuation of the unemployed is revealed through his choice.

With a new job offer, the opportunity cost of unemployment could be the value of the job offer he has turned down. The opportunity cost of unemployment for the quitter for whom getting the old job back is not an option is likely to be less than the value of the job he has given up, (unless of course the reservation wage of the quitter has risen for some reason since quitting and searching for another job or business.)

The entrant to the labor force: The entrant may or may not have a history of employment; they could be new entrant or re-entrant. The entrant may be a former full-time student, a former full-time home-maker, a former retiree, with a stint in "not-in-labor-force", or in institutions such as the military or the prison. The opportunity cost of unemployment of the entrant would depend on whether or not he is faced with a job offer. Without a job offer, the alternative to unemployment is self-employment or retirement. It is completely wrong to count the value of a job that is not for the unemployed to choose, but wish for, as the opportunity cost of unemployment. With a job offer, if he remains unemployed, the value of the job he turns down (or the jobs he could easily get but overlooks for various reasons) is be the opportunity cost of unemployment.

All in all, the opportunity cost of unemployment is likely to be less than what economists usually think it is, namely, the value of genuine alternative jobs that the

[9] The last alternative becomes more attractive with a generous provision for the unemployed.

unemployed customarily wish he had. The opportunity cost of unemployment may be higher (if one just turned down a remunerative job offer), or lower (if one has only seen rather unattractive job offers, if any.)[10] Often, the opportunity cost of unemployment for those who draw unemployment benefits will be no higher than the unemployment benefits.

One may observe that not all unemployment is voluntary, especially in the case of the laid-off and the entrant. The concept of involuntary unemployment was initially offered as the basis of expansionary macroeconomic policy. Keynes and his followers define involuntary unemployment as the unemployment that exists at the prevailing wage level that is too high to clear the market. Instead of proposing institutional reform to allow for wage adjustment, they propose expansionary macroeconomic policies to reduce unemployment taking the prevailing wage level as given.[11] But, if unemployment is *involuntary*, it does not seem that one can meaningfully speak of the opportunity cost of unemployment, any more than can one speak of the opportunity cost of blinking or a knee-jerk reaction.

III

The idea of the opportunity cost of unemployment is figurative. It is not based on the perspective of the unemployed, but on that of the whole economy, or rather of the government policy-maker. From this perspective problems of valuation noted above are ignored. Here the government is assumed to face alternative policy options that would

[10] But how high or how low cannot be determined by a third party, given the subjective nature of individual valuation. Moreover, how can one add up different individuals' valuations? In short, the idea of the opportunity cost of unemployment faces the insurmountable problem of estimation and aggregation.
[11] It is no wonder that the Keynesian approach would lead to chronic inflation, sometimes creeping, and other times galloping.

result in different states of the economy. Let's see whether the perspective of the economy as a whole makes sense in the following types of economy—centrally planned, market-oriented, and mixed.

Let's first consider a centrally planned economy. The perspective of the whole economy appears to make most sense in a centrally planned economy, in which all resources in the economy are under the government control. For example, if the government in a centrally planned economy keeps some workers idle, one could speak of the opportunity cost of idling workers as the value that could have been had had the workers not been idled. By idling workers, the proverbial economic pie is made smaller than it could be.

Paradoxically, however, the concept of the opportunity cost of unemployment does not really make sense even in a centrally planned economy. The reason is that everyone *is* already employed by the collectivist state. Strictly speaking, idling workers are not unemployed. A person is unemployed if he or she is willing and able to work, is actively searching for a paying job, and yet do not have a job. In a centrally planned economy, it is the state, not the individual, who does the searching for the individual. If the state has not found a particular job for someone, that person is not unemployed. For him idling is the job. Accordingly, the idled will get the entitled ration that the state deems appropriate. In a centrally planned economy, unemployment is literally not possible.

"Full employment" in a centralized economy, of course, is not by any means preferable. What workers at the State's disposal will do depends, in large part, on the imagination of the central planners. Whether workers will be worked to death producing nothing of value, or they will be kept idling without doing much depends entirely on the State.[12]

IV

Now, let's consider the market-oriented economy. The perspective of the economy as a whole, in which the opportunity cost of unemployment would have any meaning, is simply inapplicable in the market-oriented economy. Here, the economic outcome, including the level of unemployment, is a snapshot of voluntary exchanges among innumerable independent economic actors. As economic actors constantly alter their choices, in search for greater values, the resulting outcomes change constantly.

Life requires creation of value. A job in the market economy is a value creating process in the network of exchange. A job in the market economy entails income, or money wage. An individual may regard any occupation in which he receives money wage as a job. However, not all wage paying jobs are value-creating. A job that pays wages (or any other form of income) without creating value is not really a job. It is a disguised transfer of wealth and value-consuming.[13] In a predominantly market oriented economy, non-value-creating "jobs" would be relatively rare.

How does *a real job*, a value-creating job, come into being? The basis of a job is the decision on how to create value. In an economy with an elaborate social division of labor

[12] It used to be said that in socialist countries workers pretend to work and the state pretends to pay. In North Korea, even such pretentions have been abandoned long ago. In North Korea, a large part of able bodied adults has been officially idling since the mid-1980s. (In contrast, between the early 1950s to the early 1980s, they had been nearly worked to death in the fervent pursuit of self-reliance, *Juche*.) In recent decades, the N. Korean ruler has not only given people no job, but has regularly prevented them from getting jobs on their own, that is seeking a livelihood, driving millions to starvation.

[13] Only those who can count on transfers from others may dispense with the economic requirement of generating value. They include those who can successfully appeal to others' pity and/or generosity (involving voluntary transfers), successful thieves and extortionists, and those who can count on the government to supply what they wish.

and an extensive network of exchange, creating value for oneself involves creating value for others, (that is doing something for which others are willing to pay.) The income thus generated enables one to obtain (from others) what is really valuable for oneself.

If one knows a preferred way of creating value, one would be self-employed. The ones engaged in household production or hobbies, though they are arbitrarily classified as not being in the labor force or retired, are in fact self-employed. Of course, hobbies do not generate money income, but to the extent that value is created for oneself, it is as if one is paying oneself. Or he may be paid by whoever values his hobbies enough, (most likely, but not exclusively), his family members.[14]

A variation of self-employment is founding a business, as when the entrepreneur with a vision of how to create value seeks the help of others to complete his vision, offering jobs to others. For the entrepreneur to be able to hire others as employees, of course, the others must be persuaded that they would do better working for the entrepreneur than they could manage either by working for another entrepreneur, or by becoming self-employed. Jobs thus offered (and taken) are value-creating because the entrepreneur who offers the jobs sees them as value-creating and is willing to pay for the service he hires. As soon as the entrepreneur sees that jobs are failing to create value, naturally, he would withdraw the job offer, laying-off employees. Whether one is working for oneself or for others, a job is a value creation process.

If the entrepreneur succeeds in creating value and profits much, he and like-minded entrepreneurs will try to expand the value creation process. As the expansion requires more help, more jobs will be offered, luring people away from other lines of the value-creation process. If many entrepreneurs succeed more or less simultaneously, then the

[14] Or the government may conscript tax-payers for the maintenance of the hobbyist.

competition for workers will result in more attractive job offers (higher wages) and in a depletion of the rank of the unemployed, or self-employed. Other things being equal, rising wages (and rising price of other needed resources) will eventually choke off the economic expansion (and the explosion of job-offers) by depleting opportunities for value creation.

If an entrepreneur's attempt to create value fails, that is, if the entrepreneurial vision is not borne out, he will be forced to shrink his operation, or abandon it altogether. As a shrinking or abandon operation needs less help, job-offers will be withdrawn and employees laid-off. The entrepreneur is basically shown by the profit-loss signal that he or she is mistaken in believing that he or she could create value; the laid-off, in turn, are told that their confidence in the entrepreneur to direct them in value creation was misplaced and that they should seek some other ways to create value and generate income. In this case, *both* the entrepreneur and the laid-off will have to figure out how to create value some other way. Until they individually figure out how to create value some other way, both are unemployed, (or rather self-employed in job search, among other things.)

When many entrepreneurs simultaneously fail to create value, for any number of reasons, we would see rising layoffs, a downward pressure on wages, and an intensification of search for value-creating opportunities by many economic agents—the entrepreneur, the employed, and the unemployed. Falling wages and prices, among other things, will create an environment in which profitable opportunities becomes easier to discover for those who are intensely searching for profitable, value-creating opportunities.

In the market economy there will always be business fluctuations. But the market has a built-in process in entrepreneurship to reverse a business downturn. Formation and reformation of value-creating processes, offering jobs and withdrawing them, finding a job and losing a job, occur at all times in a dynamic economy. The processes are a reflection of economic actors trying to create the highest value possible given what they have, (as they understand it.) The observed level of unemployment at a moment is a result of the independent decisions by millions of economic agents each seeking to create the highest value possible; it is not a result of what the government (or any other entity) has chosen to do, or not to do.

Suppose that there is a high level of unemployment. If the entrepreneur (collectively) cannot figure out what to produce profitably by hiring the currently unemployed, and the currently unemployed have no higher valued alternative to unemployment or self-employment, what is exactly the value forgone? The meaning of the opportunity cost of unemployment is not clear in a market-oriented economy.

V

Let's consider the case of a mixed economy, that is, a market economy with a relatively high degree of government intervention. Here, adopting the perspective of the whole economy and seeing the government as facing various policy alternatives with different levels of unemployment appear to make some sense.

For example, suppose that the government could choose between two policy alternatives, A (the current state of the economy with 10% unemployment rate and leave it to the market forces to work things out) or B (some government action that will result in a lower level of unemployment, say 5%, the natural rate of unemployment.) If government chooses A and the unemployment remains at 10%, one then can speak of the opportunity cost of unemployment as about 5% of additional GDP that could have been produced had the policy B been adopted, instead. Of course, this perspective would make sense if a policy such as B is a real choice for the government.

But can the government really choose different levels of unemployment? How? What sort of policies would enable the government to choose among different level of unemployment? If the government indeed had the ability to choose different levels of unemployment, why would it not maintain the economy at the desired level of unemployment in the first place, instead of having to take extra action to reduce unemployment?

Be that as it may, there seems to be three possible ways the government can make difference in the level of unemployment—government-created jobs, government-protected jobs, and jobs induced by expansionary macroeconomic policies.

<u>Government-created jobs</u>: Government-created jobs include jobs at all levels of governments, jobs at government sponsored enterprises, as well as jobs at private enterprises doing business exclusively with governments. In June 2008, government employees were over 22 million, or about 18% of non-farm employees. Then one has to add the jobs at government sponsored enterprises and the like. It would be a challenge indeed to count the number of employees at such diverse entities as Fannie Mae, Freddie Mac, defense contractors, a state prison contracted out to a private firm, etc. Government-created jobs have increased steadily.

Indeed, many have argued that the proliferation of government-created jobs is what got the US economy out of the Great Depression, when the government mobilized the economy during the Second World War, creating millions of government-created jobs, as soldiers, as workers in armament industries turning out tanks, fighter planes, guns, ammunitions, aircraft carriers, etc., and as staffers in the greatly enlarged Federal government bureaucracy. Based on the episode of the Second World War, one may be tempted to say that manufacturing government-created jobs is the easiest way of eliminating of unemployment (and the opportunity cost, thereof.)[15]

Multiplying more government-created jobs, however, is not a good way to reduce unemployment. The reason is that, beyond the jobs needed for the production of minimal level of public goods, government-created jobs are not really jobs.[16] Instead of creating value, government-created jobs are predominantly disguised transfers and value-consuming. They destroy more value than they create. At best, government-created jobs tend to be a less efficient replication of jobs entrepreneurs would have created in the private sector. Otherwise, any government can eliminate the problem of unemployment by offering good paying government jobs to all who want them. In reality the society in which the majority of jobs are government-created would be rather poor. Accordingly, few would seriously regard manufacturing government jobs to reduce unemployment is a viable option.

<u>Government-protected or tax-payer-maintained jobs</u>: Government may try to avert the elimination of certain jobs at some firms, especially if they are regarded as "too big to fail" or "too politically sensitive to let them fold", by providing a privileged exemption from competition, or subsidies, or both.

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[15] In the 1930s Otto Neurath explicitly argued for "War Economy" in peace time. In 2008, the new Nobel Laureate Paul Krugman writes, "What saved the economy, and the New Deal, was the enormous public works project known as World War II, which finally provided a fiscal stimulus adequate to the economy's needs", "Franklin Delano Obama?", *New York Times*, Nov 10, 2008, A29.

[16] One must admit that during the national mobilization for a war the public goods function of government can be enlarged substantially.

The case of providing subsidies, and/or protection from competition, to struggling firms in order to save jobs which otherwise are destine to disappear is similar in nature to that of government-created jobs. That a firm is struggling, or is on the verge of bankruptcy, is an indication that the firm, which is but a collection of jobs, is not creating value, but consuming value. Instead, its rivals are creating value and better service the consumer.

By providing subsidies to struggling firms, or by providing protection from competition, the government may temporarily avert a large scale layoff (and keep the rate of unemployment from rising higher), but it ends up prolonging the value-consumption (and value-destruction) by the "jobs" in the struggling firms. As consumers do not see value in the products of the firms in question and refuse to do business with them, the government is conscripting tax payers and/ or consumers into the value consumption by the jobs thus saved, instead of allowing tax-payers to spend their money as they see fit, (which would have created other genuinely value-creating jobs in some other firms). Providing subsidies and granting privileges are not methods of dealing with the unemployment problem at all. Rather, they are methods of showering favors on particular constituents, at the expense of others.

If one compared the value of government-protected jobs, (i.e., jobs saved through subsidies and exemptions from market competition), with values lost because of them, one must conclude that the opportunity cost of job protection is far greater than the so-called opportunity cost of unemployment.

<u>Jobs owing to stimulation policies</u>: Keynes thought that the economy is prone to general economic downturns, any of which, if left unattended, may spiral downward into another

Great Depression. His followers, accordingly, argue for an expansionary policy (increasing government spending by borrowing, or print money to lower interest rates, or both) as soon as there is the sign of an economic downturn and rising unemployment rate.

An expansionary policy during a general economic downturn is meant as a short term remedy. It does not aim to create government jobs per se, nor does it aim to create long lasting conditions in which the entrepreneur can freely create jobs. An expansionary policy, instead, aims to stimulate the economy by inducing greater spending, (either consumption or investment or both), which economic agents, at the moment, are not willing to do on their own. Keynesian expansionary policies are often likened to priming a sputtering engine.

The advocates of expansionary policy are usually little concerned whether a business downturn is a symptom of entrepreneurs discovering the un-sustainability of previous business expansions, trying to correct previous mistakes, and looking for new profitable opportunities. The advocates of expansionary policy simply regard the opportunity cost of unemployment, (or more accurately, of not undertaking expansionary policy) is too great given the possibility of contagion, (or the negative externalities of a business downturn.)

Stimulating employment by creating an unsuspected inflation was one of the original proposals to stimulate employment. It is still the most favored method of dealing with a business downturn and rising unemployment. Many critics have raised questions about the efficacy of the Keynesian expansionary policy on the grounds of crowding out, policy lags, population's eventual refusal to be victimized by unanticipated inflation repeatedly, and legitimizing political opportunism in policy-making that destabilizes the economy.

The efficacy of expansionary policies has been seriously questioned after decades of ineffective counter-cyclical policies with many adverse consequences. If the efficacy of the Keynesian expansionary policy is doubtful, if the government does not face the real choice of alternative unemployment rates, the idea of opportunity cost of unemployment meaningless.[17]

VI

Creation and destruction of jobs is an essential feature of an evolving economy. At any moment some jobs are created, even as other jobs are destroyed. The constant churning of jobs reflects the relentless search for, and discoveries of, opportunities to create the greatest value possible on the part of the entrepreneur.

Any ongoing business is subject to competition from new rivals and to the possibility of job losses. If the entrepreneur discovers how to deliver greater value to consumers, they will flock to him, inducing him to expand his operation and offer more jobs. At the same time, the producers from whose goods the consumers substitute away will be forced to shrink his operation and withdraw job offers, that is, lay off employees. The fact that it often takes a long lead time before the entrepreneurial vision of value-creation is validated by the consumer should not make any difference. Jobs are created based on the expectation that the entrepreneurial vision of value-creation can be sustained. If the expectation is borne out, the jobs will be sustained and even expanded. If not, the entrepreneur will have to withdraw job offers.[18] There is nothing unusual about

[17] Since November 2008, Keynesianism has returned with vengeance, responding to the call for "do something or the world will end."

[18] How long it would take to make that judgment is on a case by case basis, depending on the requirement of finance and comparison with other available opportunities.

entrepreneurial pessimism. One's pessimism, however, is often replaced by another's optimism. Job creation and job destruction are two sides of a dynamic economy. In an economy with a growing population, there will be a net growth of jobs.

A general economic downturn is a prolonged period during which there is a large net loss of jobs. This can happen when a disproportionately large number of job offers based on optimistic projections turn sour. One may attribute the bunching of entrepreneurial misjudgments, with attendant mal-investment and untenable job offers that are eventually withdrawn, to collective stupidity of the entrepreneur, or a systemic failure. However, there is nothing better than the entrepreneurial judgment in creating jobs. Moreover, a general economic downturn of this type will be corrected itself (not necessarily instantaneously) as individual entrepreneurs try their best to figure out how to re-deploy resources to create greater value, unless the process of market adjustment is hindered by regulations designed to preserve value-consuming "jobs".[19]

The advocates of expansionary policies usually concentrate on the negative externality of business failures on other businesses, possibly creating a domino effect. Keynesian expansionary policy is meant to reverse the development by the positive externalities of the priming of the economy.

But they often fail to recognize the fact that widespread business failures (that is, a bunching of entrepreneurial mistakes) represent innumerable profitable opportunities for other entrepreneurs. That is, the negative externality of business failures and liquidation of value-destroying activities would be more than compensated by positive externalities of new ventures found on newly emerging profitable opportunities, provided that

[19] Too often the view such as this is brushed aside with a mention of the severity and longevity of the Great Depression. See P. Krugman, for example. It is necessary to go beyond the folklore of the Great Depression and to try to better understand the reasons for the severity and longevity.

entrepreneurial freedom is not severely restricted, (for example in setting wage restrictions or providing rich unemployment benefits), and government policies do not drastically and unexpectedly alter prices, (for example by restrictive monetary policies.)

Often a clustering of entrepreneurial misjudgments is a result of previous expansionary government policies.[20] If the government keeps interest rates artificially low, there will be a general over-investment. Inevitable reversals in unsustainable government policies precipitate a sudden realization that many business projections (counting on low interest rates, for example) are no longer tenable. The resultant abandonment of many business plans and a prolonged period of high unemployment, often characterized as a market failure, should rather be attributed to incentive-distorting government policies and bungled policy responses that tend to make situation worse. A general economic downturn of this type may be avoided only if the government refrained from pursuing short term political expediencies, such as expansionary policies, in the name of reducing unemployment. Once a general economic downturn of this type occurs, the only solution is to allow the entrepreneur to re-evaluate the situation and re-deploy resources to create the highest value possible. And this will be done if the prices of capital and other resources are allowed to change to reflect the changing conditions.

Unfortunately, the government is accustomed to proposing new solutions to deal with the very problems it has itself created. If a general economic downturn is caused by previous expansionary policies, (with their inevitable reversal), one would hope that the government learns a lesson not to repeat the same mistake.

Instead, the government regularly proposes more expansionary policies to deal with the perceived problem at hand. The rationale, provided by Keynesians, is that a business

[20] See Hayek and Mises.

downturn is a result of insufficient aggregate demand; the economy can be turned around and unemployment reduced if, one way or another, spending (on anything) is made to increase; people would spend money, at least a good portion of it, if it is given to them; businesses will spend it on investment if money is available to them more cheaply.[21] The short term fix of throwing money randomly at the problem may seem to temporarily alleviate the symptom, or at least meet insistent and loud political demands. However, it prolongs the process of adjustment and tends to create dependency, which calls for more intervention in the future, just as a drug addict crave for increasing doses.

VII

The entrepreneur creates value-creating jobs. He alone has the motivation and the wherewithal, the most important of which is knowledge. The entrepreneur has the desire to earn the highest profit possible, which necessarily means the highest value-creating jobs, and is motivated to use the best information available, (not as an individual who is subject to all manner of biases and limitations, but as a social class disciplined by competition.) No one else, including the government, has the wherewithal. Given this, the role of the government in the economy should be to create and maintain conditions in which the entrepreneur can freely offer value-creating jobs. All that is required of the government for this purpose is to protect persons and properties and maintain peace. In fact, these are the essence of legitimate government functions.

Unfortunately, the government often assumes a much greater role in the economy, in the process of which its legitimate functions are often perverted. For example, the

[21] After the experience of the 1970s and criticism from the Monetarist and Rational Expectations Schools, expansionary policies are seldom explicitly rationalized by money illusion.

government nowadays routinely assumes that its main function is the redistribution of income and wealth, subjecting private properties to arbitrary seizure and thus undermining the security of properties. In addition, the government is all too eager to encumber the entrepreneur with various dos and don’ts, in the name of safety, health, human dignity, and environment, preventing the entrepreneur from freely pursuing value-creating activities, i.e., preventing him from offering value-creating jobs. Instead of removing old rules that are becoming increasingly odious with the passage of time, the government daily introduces new restrictions that progressively impinge on entrepreneurial freedom.

The pervasive interference of government in the economy creates a condition in which certain value-creation processes are legally forbidden and even permitted activities are burdened with various requirements, ultimately increasing the cost of doing business. Under the circumstance, the level of unemployment would be higher than it would be with fewer restrictions. To the extent that welfare programs render the state of being unemployed less painful, the natural rate of unemployment will rise. Many economists would agree that various labor regulations and social insurance schemes raise the natural rate of unemployment. The perpetuation of a higher level of unemployment, and the associated losses of value, is the opportunity cost of intrusive government that neglects its essential functions. But this cost is often overlooked because the permanent job losses, from the heightened natural rate of unemployment, is independent of cyclical downturns and therefore regarded as “natural”.

VIII

So what about the idea of the opportunity cost of unemployment? The opportunity cost of unemployment is what the unemployed incurs voluntarily. From the point of view of the unemployed, the opportunity cost of unemployment—the highest value of jobs turned down, or self-employment—is lower than the value of being unemployed with the prospect of finding a more agreeable employment in the future, plus any transfer benefits that make job search less urgent. Otherwise, the unemployed would not have been unemployed. It is subjective and impossible to objectify and meaningless to aggregate across individuals.

When economists describe the opportunity cost of unemployment as the GDP that the unemployed could have generated had they been employed, they assume that varying levels of unemployment are real alternatives for the government.

But in truth the economic outcome is not decided by the government; it cannot create value-creating jobs, real jobs, except on a very limited scale in producing public goods. It is the entrepreneur who creates jobs in the pursuit of profit. What the government can do is to create conditions in which the entrepreneur can freely create jobs by protecting persons and properties, and securing peace.

Nevertheless, advocates of active government believe that periodic general economic downturns are a sign of market failure that must be urgently attended to lest things go out of control and become full blown depressions. They confidently argue that an expansionary policy during a recession will reduce unemployment. As expansionary policies divert resources from other uses, their advocates commit the fallacy of broken window, focusing on the stimulus of expansionary policy (the seen), ignoring what it forecloses (the unseen.)

Let's suppose, for the sake of argument, that expansionary policies are effective in temporarily reducing unemployment rate. The opportunity cost of unemployment, (or rather of non-expansionary policy during a recession) is the portion of unemployment that might have been avoided through expansionary policies. But then what is the opportunity cost of expansionary policies? Remember: "there is no such thing as a free lunch." The opportunity cost of expansionary policy must include the value-consumption/destruction from prolonging the misallocation of resources, by making liquidation of mal-investments less urgent and developing dependency on repeated short term fixes. To the extent that social insurance to ease the pain of the unemployed and restrictive labor legislations to protect jobs, viewed as built-in counter-cyclical policies, raises the natural rate of unemployment, the value lost due to higher natural rate of unemployment must be included in the opportunity cost of expansionary government policies to deal with the unemployment problem.

It comes down to the comparison of two costs—the opportunity cost of non-expansionary policy and the opportunity cost of expansionary policy. The widely shared view among economists is that the former is greater than the latter. I wonder whether the view has been subjected to rigorous inquiry.

References