

Cause and affect of unemployment in malaysia economics essay



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Unemployment is a very important issue for every country, especially developing country with a tremendous population. High unemployment means that labor resources are not being used efficiently. In consequence, full employment should be a major macroeconomic goal of government. This essential issue often being included in the government policy or agenda for parliament debate and discussion year after year. After a long period of discussion and debate, it seems no ultimate solution has been found to completely eliminate unemployment.

Theoretically, industrial economies are cyclically sensitive as such when it expands, factors including employment, sales, prices and profits will rise. However, when it contracts, downturns are inevitable and significant (Nazaria, 2003). When our national economy is in recession, many firms and companies are close down, it will cause unemployment rate to increase.

The financial crisis that started in mid 1997 has affected the Malaysian economy. The impact was evident with the economic growth measured in real GDP began to slow down and registered the first negative growth since 1985 of -7.4 per cent in 1998. Table 1 depicts real GDP growth, labor force and unemployment from 1996 -2003 (UKM Juru Perunding, 2002). The contraction in real GDP affected the labor market resulting in slower employment growth, increased in the unemployment rate and also retrenchment. Labor force registered negative growth of 2.1 per cent and employment declined by 2.8 per cent in 1998 compared to a positive growth of 4.9 and 4.6 per cent in 1996 and 1997, respectively. In the same year, unemployment, on the other hand, experienced a slight increase standing at

3. 1 per cent. Retrenchment soared to 83, 865 workers in 1998 compared to approximately 19, 000 in 1997 (EPU, 1999).

Table 1: Real GDP Growth, Labor Force, Employment, Unemployment, Labor Force Participation Rates, 1996-2003

Sources: Nazaria B., 2003: Working paper of Unemployed Graduates: Pre and Post 1997

Crisis.

Okun's Law, stated that there is a negative relationship between unemployment rate and real GDP. Okun (1962) found that a deviation of 3 per cent in the GDP will produce a rise by 1 per cent in the unemployment rate. Besides that, Zaleha, Norashidah & Judhiana(2007) prove that Okun's Law can be applied to explain Malaysia's condition. Results of Table 2 showed that the value of the t-statistic for the coefficient (5. 796) is greater than the critical t-value at the ninety five percent confidence level (1. 96). This proves that GDP strongly depends on unemployment. Unemployment is one of the main mechanisms that can affect GDP. On the other hand, the result also confirmed that there is a negative relationship between unemployment and output growth. The Coefficient is -1. 75 and it is significant at 1 percent level. It means that one percent decline in unemployment will increase output by 1. 75 percent. As a result, it will increase the growth rate of the GDP.

Table 2: Results of Regression Analysis

Sources: Zaleha Mohd Noor, Norashidah Mohamed Nor & Judhiana Abdul Ghani

(2007). “ The Relationship between Output and Unemployment in Malaysia: Does Okun’s Law exist?” Department of Economics, Faculty of Economics and Management, Universiti Putra Malaysia, Pp. 6

1. 2 Objectives of the Study

The overall goal of the study is to examine the factors that cause and affect the unemployment in Malaysia. It is important to identify these factors in order to find solutions which can reduce unemployment rate.

The study aim to investigate the factors that cause unemployment such as consumption, investment, government spending and trade. They affect the supply and demand in the labor market. While economic recession may cause lack of job opportunity in the job market.

Moreover, this study also intends to develop some solutions to solve the problem of unemployment. It is expected that this study will achieve the research objective and highlight some important issues which relate to unemployment.

1. 3 Organization of Research Study

This study is organized into 3 chapters that will address the overall objective of the research. Each chapter will also serve the purpose of delivering the research following its title.

Chapter 1 briefly introduces the research topic “ Relationship between Unemployment Rate and Economic Growth in Malaysia”. Meanwhile, the research objective will be to study the consumption, investment, government spending, as well as the trade that affect economic growth and caused unemployment in Malaysia.

Chapter 2 seeks to support the study by providing various relevant journals and articles on the area of interest of the research. This is also the proof of reading the literature relevant to the area of study.

Chapter 3 discusses the strategy and method used to collect the data. The research frameworks consist of four independent variables, which are consumption, investment, government spending and trade. Meanwhile, unemployment will be the dependent variable. Secondary data collected from Data Stream and research methods are decided.

1. 4 Significant of Study

The information gained from this research will be able to provide valuable solution to reduce the unemployment rate in Malaysia. It will also provide Malaysia government with an idea on how important is to reduce the problem of unemployment rate. Reducing the unemployment rate may lead to a better economy in Malaysia due to the increase in productivity of Malaysia. A growth of national income, higher Gross Domestic Product (GDP) in Malaysia will then be achieved while the nations will have higher purchasing power and can lead to a better quality of life.

Investment, indeed, brings a lot of job opportunity in the country. Whenever foreign direct investments (FDI) invest in the country, there will be a lot of <https://assignbuster.com/cause-and-affect-of-unemployment-in-malaysia-economics-essay/>

industry set up for production and administration. Thus labor demand will be increased due to the investment. It then decreases a certain amount of unemployed.

Another factor to reduce the unemployment is through the government spending. Government needs to build and construct many of the facilities in the country for the society's benefits. Government needs to spend on construction of big projects; this injection of money will help to create the job opportunity for the labor in the country.

Unemployment will be decreased.

Trade is one of the factors to reduce the unemployment as the working opportunity is created when two countries trade. Increasing of trade internationally meaning there will be an up surging of export. Thus, domestic supply of goods is needed to meet the international demand. From that, the people have an opportunity to produce and manufacture new product for the trade among the countries.

1.5 Research Question

The research question for the study would be “ Relationship between Unemployment Rate and Economic Growth in Malaysia”. Several independent variables affecting the unemployment rate will be investigated to see how actually it will influence the economic growth in Malaysia.

The details of the study are:

To study the consumption pattern affect the economic growth.

To investigate whether investment affect the unemployment rate.

To examine whether government spending affect the unemployment rate.

To study the effect of trade on the unemployment rate.

1. 6 Problem Statement

Unemployment is a negative issue that may arise in every country around the world. As long as a person is involved in the labor market, he or she may one day become unemployed. Once unemployment issue is not solved, creation of problems to the unemployed graduates, nations, society and even the country will certainly arise. Furthermore, if the nation's unemployment continues to be severing, riots and insurgency will be occurring across the country and halting the country trading. A significant lost towards the nation will arise due to this serious problem. Solution for the unemployment problem is a priority of the government to include in the national economic planning and policy implementation. In this research, focus will be placed on how economic growth effects unemployment and their relationship.

Chapter 2 Literature Review

2. 1 Definition of Unemployment

According to International Labor Organization (ILO, 2001), unemployed is persons who are above a specified age are without work, currently available for paid employment or self-employment, and actively seeking work.

There are three categories of unemployment,

Structural Unemployment

Structural unemployment is related to the mismatch in skills, as well as the inadequacy in locations or simply the wrong area desired for work, and interpersonal characteristics. For instance, as the technology is improving and changing in the market often causes many skills possessed to be obsolete. With the advancement of computer many jobs in manual book-keeping have been replaced by highly efficient and handy software.

Frictional Unemployment

Frictional Unemployment is resulting from temporary transitions made by workers and employers. This type of unemployment occurs when there are fresh graduates trying to enter the job market, searching for job of their choices.

Cyclical Unemployment

Unemployment that is attributed to economic contraction is called cyclical unemployment. The economy has the capacity to create jobs which increases economic growth. When the economy is in recession, firm will reduce production and it lead to the decline of labor demand. Thus, cyclical unemployment will rise sharply during recession.

2. 2 Unemployment in Malaysia

It is essential to look at the unemployment trends in Malaysia for the period ranging from 2000 to 2009 (Figure 1). By observing the figure, unemployment rate remained moderate at approximate 3 percent.

Unemployment rate increases steadily from 2001 to 2004. On the year 2001, the 911 incident, US World Trade Centre was attacked by terrorists (Terence Tai-Leung Chong, 2005). This attack marks the beginning of the US economy downturn. It then affects the whole world economy to decline. Being the largest economy in the world, US needs to import tremendously from the rest of the countries. Thus, US economy downturn has decreased its import and the world's export will decline as well. When the decline of export for the country, it will directly cause the down fall of the country's economic growth as the productivity has been reduced . Therefore, the global economy will be sluggish. Hence, unemployment rate in Malaysia is 3. 7 percent on 2002.

During 2003, Malaysia was hit by double critical incidents which were Severe Acute Respiratory Syndrome (SARS) and Iraq War (Robert Evans, 2003).

Unemployment rate was 3. 8 percent which has increased 0. 1percent. There was an immediate effect from the outbreak of SARS and Iraq War due to the large amount of inter-regional trade. SARS and Iraq War have triggered a global downturn therefore affect the world economy into recession, and lowered world growth forecasts. SARS epidemic was concentrating in Asia which is the fastest growing economy in the world and that had basically been keeping the world economy to float.

Malaysia has gone through East Asia financial crisis during 1997. Thus, Malaysia has the ability to combat and survive during the sub-prime crisis. Some efforts of the policy maker have made to strengthen the domestic economy. Policy maker has implemented several monetary policy as well as fiscal policy to stimulate the economy. The increasing trend and steady

growth in the Malaysia's Leading Index (LI) and the ratio of the Coincident
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Index to Lagging Index in 2007 (Public Bank Berhad, 2007) indicates that the Malaysian economy was continue to remain strong and healthy in 2008 which US sub-prime mortgage crisis deceleration in the US economy.

Figure 1: Unemployment Rate in Malaysia

Sources: Indexmundi. com (2008). Malaysia – Unemployment rate (%). Retrieved

November3, 2009. Website: <http://www.indexmundi.com/g/g.aspx?c=my&v=74>

During a period of high unemployment, employees worry about losing their job and not able to get another job. Other than that, workers are less willing to leave unsatisfactory jobs because it is not easy to be hired at this current period. This may cause a decrease in production because workers are lack of experience in their current job. Higher unemployment rate will also affecting the government tax revenue. It is because there are more workers losing their jobs and leads to decrease in government revenue from income tax.

2. 3 Factors that affect Unemployment

There are four independent variables that affect unemployment which are consumption, investment, government spending, and trade.

2. 3. 1 Consumption

Based on the study by Castillo, Dolado & Jimeno (1998), the result showed by using one cross-section of household per county, by comparing with the employed workers, the consumption losses suffered by the unemployed were 50% to 100% higher in Portugal and Spain, depending on the worker's job

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experience and skills. Besides, Bover et al. (2000) found that the unemployment benefits systems in Spain are more generous than in Portugal.

According to Samuel et al (2001), an increase in the duration of unemployment of male household heads tend to be connected with consumption losses in Germany, Great Britain, and the US than Spain and Italy. Also, in terms of ' married' households, Browning and Meghir (1991) found that the husband is unemployed in a married household have budget shares for clothing of 35% lower than the husband is being employed.

There are two authors have proven that consumption suffers downfall during unemployment. Cochrane (1991) reported a fall in consumption growth of 24% to 27% during unemployment. On the other hand, Browning and Crossley (2001) also proved that a mean fall in consumption of 14% on unemployment.

Browning and Crossley (2000) deal with the effect of income shock due to unemployment on consumption. Individuals experiencing an income shock may reduce consumption on durable expenditure than on food expenditure. For example, they may postpone to buy new jewelry or to replace new furniture.

2. 3. 2 Investment

According to Harms and Hefeker (2003), the returns of portfolio investment abroad are positively correlated with U. S. labor demand shocks. When there is more investment, it generates new jobs; therefore labor demand will

increase accordingly. Thus, this will aid in the decrease of the unemployment rate.

Erkki Koskela, Rune Stenbacka, and Mikael Juselius (2009) study the effect of the unemployment equilibrium with capital investments under the category of labor market imperfections. By showing a higher capital, labor ratio has a wage-moderating effect with sufficiently strong labor market imperfections, the strategic effect of capital investments. Based on this appliance, an increased capital stock decreases unemployment equilibrium if the relative bargaining power of the labor union is sufficiently strong.

Marino (2000) showed the interdependency between FDI, economic growth, employment or explanation of factors for stimulating the FDI inflow in the case of open economies. The GDP growth is positively correlated with the capacity of FDI inflow. On the other hand, the relationship between GDP growth and FDI inflow is rather contrary in the case of closed economy.

Christoph Ernst (2005) studied that a country needs stable and productive investment inflows which would contribute to a rise in production rate and employment, to the technological modernization of the economy, as well as the production of higher value added goods resulting in a better integration into the world economy.

There is a strong correlation between national productivity and the level of unemployment (Joseph Prokopenko, 2000). In a situation where the economy is productive and competitive, there will be contest in the foreign market.

Thus, it lowers the unemployment rate. However, investment will increase

due to the high production rate. Then, it will create new job opportunities
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and the employment rate will increase as well. Hence, investing in a productive market is a source which can create new market and then increases the job opportunities in the market.

According to Borensztein, Gregorio & Lee(1998) and Yussof and Ismail (2002), FDI will introduce technology and management skill into the domestic firm to enhance the productivity. They may bring towards new technology into the domestic market. Thus, domestic labor will have a chance to upgrade and equip themselves with knowledge from the new technology and systems. FDI have positive effects on domestic unemployment, according to Lall (2002). FDI leads to increase the value of human capital accumulation. Labor will always get new knowledge from new technology so that they will be able to suit themselves into the specified occupations or jobs. Then, unemployment rate will decrease, hence, strengthening the economic growth of the country.

On the other hand, Blomstorm, Fors & Lipsey (1997) found that FDI will retain unskilled jobs at home country when more skill-intensive activities are allocated to the foreign country. Foreign investors will leave jobs which do not need much of labor skill work at their home country and relocate more labor-skilled works abroad. This way, the investors would be able to save in training cost by investing in foreign countries which have abundant skillful workers.

2. 3. 3 Government Spending

Government programs are the largest source of counterbalancing the income against household earnings shocks arising from the unemployment

in the U. S. (Dynarski & Gruber, 1997). Agell, et al. (1997) noted that the government purchases and transfers can enhance employment thus strengthening and stabilizing the economic growth of the nation.

Spending on infrastructure will create more jobs opportunity (Kenyon, 1997). Government spending can raise labor productivity and also complements the investment from private sectors. Subsequently, the demand for labor will increase, hence, decreases the unemployment rate. The whole process of government spending is like a catalyst that can stimulate the overall economic activity and growth in the country.

According to Feldstein (1978), due to the unemployment insurance and taxation on labor income could deform work-leisure decisions, and it increases unemployment rates. Even if they do not have a job, they could still get the unemployment insurance to support their daily lives. Thus, this will result in a negative manner where labors will depend on the unemployment insurance instead of working hardly. On the other hand, the increase in income tax will lead to unemployment because income taxes charge according to personal income of individuals. The higher the income, the higher the taxes the person needs to pay. Everyone work so hard to get better income for a better life and yet they need to pay higher tax. Hence, there is this mentality where they would choose or decide not to work hard or be jobless, so that they would be able escape from being 'oppressed' by the government with income taxes.

2. 3. 4 Trade

According to Brecher (1974), the unemployment rate could rise or fall after trade depending mainly on whether the country exports labor-intensive goods or not. It shows under the Heckscher-Ohlin model. Davis (1998a, 1998b) further discussed about the effect in a two-country framework. If home country produces and exports labor intensive goods, then the employment rate will increase.

Matusz (1996) explored the consequences of opening to trade on the unemployment rate using the efficiency-wage framework. Open to trade will create intra-industry trade. It creates new jobs opportunity and then reduces the unemployment rate.

According to Brecher (1974) and Davis (1998), their study found that trade liberalization can reduce unemployment rate. Foreign workers are able to go to other countries anytime if there is no existence of the barrier of trade. Thus, a country's supply of labor will be excessive and it reduces tremendously, the job opportunity for domestic labors. Besides, frictional unemployment in comparative advantage model was introduced to find whether any relationship lay on a comparison of capital-labor benefit across countries (Davidson & Matusz 1988). For a country that produces capital intensive goods, labor skill is not in need for its production, thus, unemployment rate will increase.

Besides, fair wages has been introduced into a model with increasing returns to scale and trade liberalization of trade that would increase the unemployment rate (Egger and Kreickemeier, 2009). Labor wages in home

country will be affected due to the excess in foreign labor supply. It reduces domestic wages and also reduces the chance of domestic worker to get a job at home country. As for one of the consequences, domestic unemployment rate will increase dramatically.

Helpman and Itshoki (2008) combined the comparative advantage consideration and increasing returns to scale by using search-matching approach. In conclusion, globalization can affect the increase of unemployment rate. Foreign workers can enter into the domestic labor market in a country, with cheap labor wages, that will result in the reduction of domestic wages as well as reducing the chance of domestic workers to get a job in their own country. Unavoidably, the domestic unemployment rate will increase.

According to Thomas (2004), Malaysia is heavily depending on foreign trades, the nation's exports account contributes large proportion of GDP, and manufactured goods are one of the main exports of Malaysia. As Malaysia is dependent on generating revenue through exports, many problems would occur if the exporting sector fails. Mainly, it will cause a major unemployment issue that would cause many of its people to suffer economic downfall. This is because manufacturing factories fail to sell and export their products, causing them to face financial problem. Therefore, it would result in the closing down of the factory, thus, the unemployment rate rises.

2. 4 Unemployment Benefits in Malaysia

Unemployment benefits system is a benefit which is for eligible workers who become unemployed. Unemployment benefits consist of unemployment

insurance and unemployment assistance. Unemployment benefits are available to the eligible unemployed only. The term “eligible” here means an unemployed individual which is in a condition of ready, willing and able to work on the go (Eva Liu, Walter and Kwong, 2000). Many studies have proven that unemployment benefits effectively smoothens consumption during unemployment. According to Gruber (1997), he found that the nation’s budget on consumption expenditures would fall by 22 percent without the presence of unemployment insurance. It is proven from the study that unemployment could deteriorate not only the population’s welfare but as well as the country itself. Furthermore, according to Kugler (2002), a study has made showing that the withdrawals from unemployment insurance savings account cause an increase of consumption level by unemployed household in Colombia.

Martin Borowing & Thomas Crossley (1996) discovered the impact of unemployment benefits to household welfare through the chain below. In general, their research study has concerned and included the overall link from unemployment benefits to its expenditures. As the result, they found out that a 5 percent cut in unemployment benefits level will cause an expenditure fall by 0.3 percent. The unemployment benefits as a major income for unemployed household have significantly larger falls in consumption. Also, some of the studies have been reviewed. For instance, the author reviewed Kell and Wright (1990) and Lundberg (1985) studies which were the relationship between personal income and household income depending on the reaction of earnings by other family members.

Household Expenditure Household Utility Level

However, Malaysia does not have any unemployment benefits system but the government has prepared a several types of welfare benefit system.

2. 4. 1 Severance Pay

Severance pay, in Malaysia, is regarded as a form of unemployment-related benefit for both employers and employees (Eva Liu, Walter and Kwong, 2000). Those workers, whose earnings which are not exceeding RM 1500 per month, irrespective of their earnings are covered under the employment Act 1955, will be provided for severance pay. Severance pay is known as retrenchment benefits, or termination and lay-off benefits in Malaysia. The rate is paid at the following rates:

10 days, 15 days, 20 days wages for each year of service for an employment shorter than two years, longer than two years but shorter than five years, five years or longer, respectively.

Severance pay is expected to be sufficient to meet the basic need of an unemployed worker until the next job is found. But, one must be clear that, severance pay is not equivalent to unemployment insurance or unemployment assistance.

Recipient employees do not need to have any prior contribution, neither the recipient employees are required to be able to work, nor willing to working or in the mode of finding work, in order for him to receive severance payment. Severance pay is made to an employee solely on the basis of termination of contract by the employer.

2. 4. 2 Employees Provident Fund

The Government has set up the Employees Provident Fund (EPF), a social security organization that provides retirement benefits to private sector employees and non-pensionable public service employees. Under the Employees Provident Fund (EPF) Act 1951 (Malaysia, 1951), it is compulsory for all employers and employees to contribute towards this Fund. Employer need to contribute 12% for his employee's EPF at the same time, employee need to contribute another 11% for himself from his monthly wages into his EPF savings.

This fund provides benefits for old citizens, disability and death.

Nevertheless, it does not provide cash assistance to any employee who is unemployed and the money can only be withdrawn when one reaches the age of 55.

2. 4. 3 Work Injury Insurance

Work injury insurance is treated as a kind of employment related benefit in Malaysia. The Social Security Organization (SOCSO), a statutory body, administers payment of benefits under the Employment Injury Scheme and Invalidity Pension Scheme. The Employment Injury Scheme provides protection to employees who are involved in accident during work. On the other hand, Invalidity Pension Scheme provides 24 hours coverage for employees from invalidity or dies irrespective of the cause of death.

Although these two schemes are not somewhat unemployment-specific, an unemployed worker could benefit under these schemes. That particular individual is covered whenever an injury or invalidity happens during his/her immediate past employment. This indirectly categorizes those two schemes, <https://assignbuster.com/cause-and-affect-of-unemployment-in-malaysia-economics-essay/>

as the unemployment benefits system which is practiced by other countries (Eva, L.& Walter, K. 2000).

2. 4. 4 Services for the Poor

In Malaysia, under the Destitute Person Act 1977, public assistance is available to households with monthly income of less than RM460. Families which suffer from poverty due to unemployment, aging, illness or even disability, may apply for assistance under this program (Eva, L.& Walter, K. 2000).

2. 4. 5 Labor Laws

There are various labor laws in Malaysia that specify the obligations of employers with respect to the workers' benefits which is mainly related to sickness, maternity, and termination. In other words, basic protection, such as mentioned above, has to be provided by the employers for their employees. The principal labor laws on these matters are the Industrial Relations Act 1967, the Employment Act 1955 for Peninsular Malaysia, the Labor Ordinances of the states of Sabah and Sarawak. The formula for the benefits is specified in the relevant laws. Certain sectors have their standard cover or benefits for those who are related within the sector itself. For instance, those in the plantation sector are accorded certain minimum benefits such as housing and medical benefits the Workers' Minimum Standards of Housing and Amenities Act, 1990.(Soh C. S, 2007)

2. 5 The effects of Unemployment on Social Issues

Unemployment is one of the major causes of many social and economic problems, such as the imbalance of social status among the populations or

the increase of vice activities. Social problem is pin pointed in this discussion. Of many countries around the globe, Malaysia is not excluded from getting involved and dealing with crime offence issues every day. The phenomenon of crime wave has received an increasing attention and the criminal activity has been given wide coverage in the newspaper and media (Muzafar Shah Habibullah & A. H. Baharom, 2008). As proposed by Becker (1968) and Ehrlich (1973), however, criminal activity in Malaysia does not attract the attention of the people across the globe and remains largely neglected by the economics of crime literature.

Economic condition seems to be one of the most important macroeconomic variables affecting crime. According to the economic models of crime such as Becker (1968), when a nation's economy is stabilized, fortified and becomes stronger, this would open more opportunities for the citizens to get themselves involved in the nation's workforce. When individuals earn their income legitimately, the possibility or tendency of an individual to get involved in crime related activities would be greatly decreased, thus, relatively decreases the crime rate.

According to Pichaud (1997), unemployment can cause a humongous social and economic cost to a country's budget. Every problem arises would have its consequences, for instance, when the unemployed are faced with financial problem, hence, those individuals will be in poverty and in debts due to the inability to pay up their levies. The matter would be worse for those individuals having to support their family members. Once the population is in the state of poverty, they would be thinking of possible ways, legally or illegally, to get money in order to support their daily life expenses.

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According to Ehrlich (1973), he predicted that when opportunity cost in illegal activity is low, then unemployed will get involved in criminal as they can get better payoffs. Therefore, there are certain kinds of criminal activity are directly linked to unemployment. Jahoda (1982) has linked unemployment to family disruption, suicide, health problem, drug addiction, malnutrition, poor prenatal care, school dropouts, racial and ethnic antagonism, and other possible social problems.

On the other hand, a study proved a relationship between GDP per capita and robbery rate. The study tells that an increase in GDP per capita is associated with a significant fall in the robbery rate (Fajnzylber, Ledeman, & Loayza, 2002). This result supported by economic cycles which have a strong impact on crime. There is many other studies that prove and support the statement that strong economic performance may reduce criminal rate such as Pyle and Deadman (1994), Deadman and Pyle (1997), Hale (1998) and Masin and Masih (1996). Unemployment could affect the lifestyle of the society as this is strongly related to stress management. For an example, when unemployment occurs, this would increase