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Econ 321

Weeks 3-4: Labor Market Regulation and Labor Unions

I. Unemployment As a Labor Surplus
   A. Intuitively, we often think of "unemployment" as a situation where people who are willing and able to work are somehow denied the chance to do so.
   B. At the equilibrium wage, there are neither labor shortages nor surpluses; unemployment is <u>voluntary</u> (not in the sense that it is cause for celebration, but in the sense that people do not want to work more **at the market wage** for jobs they are **able** to do).
      1. Analogy: Voluntary datelessness.
   C. So how is <u>involuntary</u> unemployment possible? *Only if the prevailing wage is too high!*
   D. This is no different from any other surplus good. "Surplus" means "surplus at the current price."
   E. More generally, there are only three possibilities:
      1. Market wage=equilibrium wage; the labor market clears.
      2. Market wage<equilibrium wage; there is a labor shortage.
      3. Market wage>equilibrium wage; there is a labor surplus.
   F. Note: there is no case where workers are *both* "under worked" and "underpaid." If they are under worked, they are overpaid; if they are underpaid, they are overworked.
   G. This simple application of S&D runs contrary to almost all popular beliefs about labor. But there can be little doubt that it is correct.
   H. The general solution to all involuntary unemployment boils down to: reduce the market wage until the surplus disappears.
   I. The "buy-back-the-product" fallacy. Does reducing wages "reduce demand"? Of course not. Lower wages may mean less income for employ*ees*, but also mean more income for employ*ers*.

II. Unemployment on the Free Market: Wage Fairness and Unionization
   A. Economists standardly assume that unregulated markets clear. Could this assumption be wrong in labor markets?
   B. Case 1: Wage fairness. There is good evidence that workers regard wage cuts as "unfair."
      1. Review: real versus nominal wages.
   C. Perceived unfairness hurts morale, which typically leads to lower productivity. So employers are reluctant to cut wages when labor demand decreases or labor supply increases.
   D. The result: if equilibrium wage is below prevailing wage, jobs will be "rationed." Qualified, willing labor remains unsold *because workers are overpaid.*

E. Interesting: employees seem to resist *nominal* wage cuts much more fiercely than *real* wage cuts. Nominal wage cuts hardly ever happen; real wage cuts are far more common.

F. How serious would the problem of surplus labor be under laissez-faire? It would definitely exist, but the historical record suggests that it would be fairly mild.

G. Case 2: Unionization. Unions are basically labor cartels; their goal is to push wages up by restricting competition between workers. Unions are "price-fixers."

H. The natural side effect is to create labor surpluses. Ideally (from the union's point of view), the surplus workers won't belong to the union anyway, so none of the members suffer. In practice, though, the unemployment often spills over onto union members.

I. In economic terms, what are "scabs"? They are workers who undersell the cartel. If enough scabs exist, unions have little success.

J. Assuming the government prevents violence and threats of violence, it is difficult - though not impossible - for unions to keep wages up. They succeed best when:

   1. Labor demand and labor supply are highly inelastic. Small, highly skilled craftsmen are a good example.
   2. The social stigma of "being a scab" is very high.

K. Under laissez-faire, involuntary unemployment created by unions would again exist, but not much of it. As long as employers can legally hire non-union workers, and non-union workers feel physically safe to accept such offers, market forces sharply check the power of unions.

III. Unemployment on the Free Market: Corrective Government Policy

A. Is there anything government could do about the preceding problems? In principle, yes.

B. For real wage rigidity, intervention could help by pushing wages *down*. If workers blame the government instead of the employer, presumably they don't blame the employer for being "unfair."

C. For nominal rigidity, the government has an easier solution: print more money to raise the price level until the nominal wage clears the market. If workers are clueless, they may never "see what hit them."

D. Similarly, unions might be banned, much as other cartels are illegal under the antitrust laws.

IV. Government Policy in the Real World, I: The Minimum Wage

A. In the real world, government policies bear little resemblance to the kinds of "corrections" economic theory points toward.

B. It is almost impossible to find governments that try to force wages *down*. Instead, governments around the world deliberately push wages *up* and prevent market adjustment.

C. Classic example: the minimum wage.

D. Suppose the equilibrium wage is $10/hr. If the government imposes a minimum wage of $15/hr., there will be unemployment. Employers will want to hire fewer people than want to work at the market wage.

E. Simple question for proponents: Why not $1,000,000/hour?

F. Interesting: Unions of skilled workers often support the minimum wage strongly. Altruism for unskilled workers, or masked self-interest?

G. In the U.S., the minimum wage itself is fairly low (less than 5% of the U.S. workforce earns it). In other countries like France, the minimum wage affects a large percentage of the workforce.

H. Even though most governments deliberately try to push wages up, at the same time many also try to erode real wages by inflating. (Whether they think of it in these terms is another matter).

I. Yet reducing unemployment with inflation often fails. Employed workers catch on and negotiate cost-of-living adjustments, leading to spiraling inflation.

J. In some cases, one arm of the government actively tries to undo the harm done by the other arm. One branch raises the (nominal) minimum wage, the other tries to reduce the (real) minimum wage via inflation!

    1. What does the real minimum wage look like when inflation is always positive?

Kennan: The Elusive Effects of Minimum Wages 1955

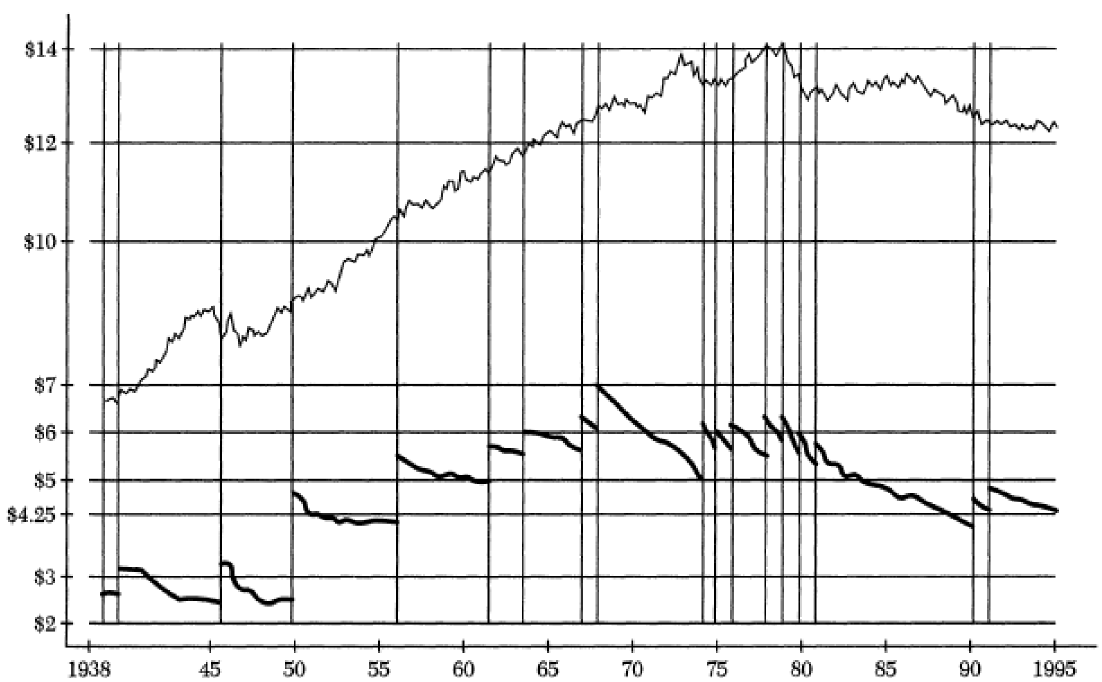


Figure 2. U.S. Real Minimum Wages and Average Wages of Manufacturing Production Workers, $1995

V. Government Policy in the Real World, II: Pro-Union Laws
   A. It is much more common for governments to encourage unionization than it is to make it illegal. Pro-union efforts by governments take a variety of forms.
   B. One of the most common is to "look the other way" in the face of union violence against strike-breakers, employer property, etc. Laws limiting union liability serve the same function.
   C. Some more explicit regulations:
      1. Require employers to "recognize" and "bargain in good faith" with any union that gains the support of a majority of workers in a firm.
      2. Making it illegal to fire workers for striking or union organizing.
      3. Banning "yellow dog" contracts, where employees are non-union as a condition of employment.
   D. When governments strictly enforce pro-union regulations, levels of unionization - and unemployment - can reach high levels.
   E. Other countries with the same laws on the books may escape most of the bad effects by weak enforcement.
      1. Alternate book title: "Why U.S. Unemployment Is So Low"

VI. Additional Labor Market Regulations
   A. There are numerous other laws that work much like the minimum wage. Even if their short-run effect is to increase labor demand, the long-run effect is exactly the opposite.
   B. What happens if the government adopts the following measures, while forbidding wages to fall? (Alternately, if strong unions prevent wages from falling).
   C. Case 1: Mandated benefits. What if the government mandates new benefits (safety, health, family leave, etc.) and forbids wages to fall?
   D. Case 2: Regulations against lay-offs and firing. How will employers respond if they know that they must continue employing workers they don't need? Are bad at their job?
   E. Case 3: Plant-closing laws. What if the government penalizes firms for (or forbids) closing plants?
   F. Case 4: Employment lawsuits. What if employees can sue their employers for discrimination, harassment, unfair termination, etc.?
   G. Case 5: Mandatory overtime. What if employers are legally required to pay "time-and-a-half" for overtime?
   H. How do these results change if wages are flexible?
   I. Related regulation: Unemployment insurance, welfare, and so on reduce the supply of labor. If they are generous enough, they can "convert" involuntary unemployment into voluntary unemployment. This in turn reduces downward pressure on wages.
      1. How can this be graphed?

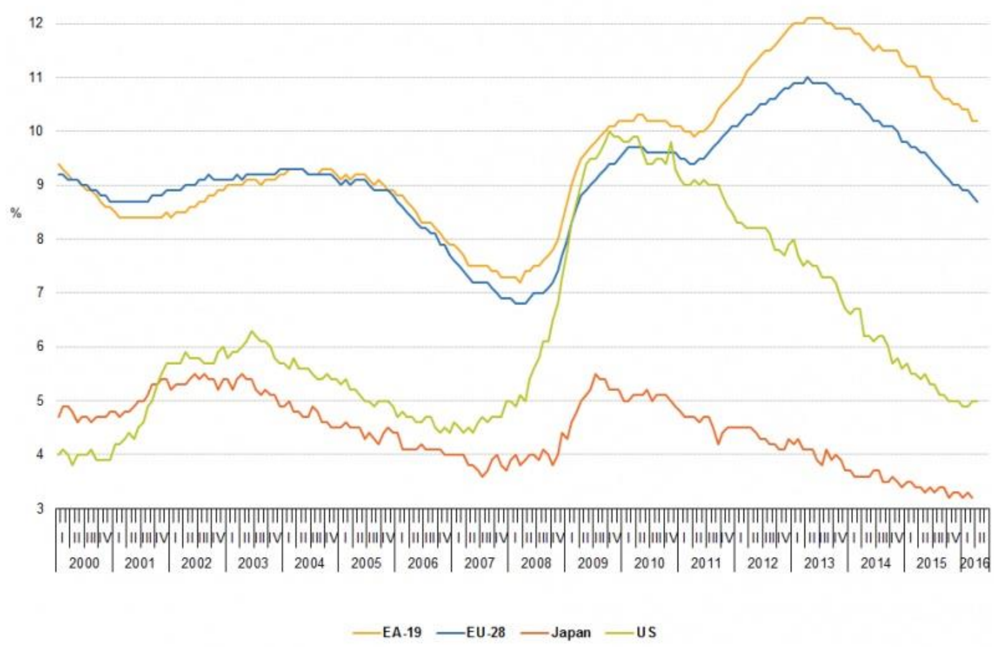
VII. Application: European Unemployment

A. Labor market regulations in Europe are typically very strict. Over the last twenty years, the average U.S. unemployment rate has been roughly 6%, versus 9% for Europe.
B. Most economists blame European countries' stricter labor market regulations.
C. What have European labor policies been like?
    1. High legal minimum wages. (E.g. 34% of median in U.S. vs. 60% in France).
    2. High unemployment/welfare benefits with long durations.
    3. Firing/layoff regulations.
    4. Mandatory benefits (vacation, sick leave, maternity leave, etc.) (How does the interaction between mandatory benefits and nominal and real rigidity work?)
    5. High unionization rates with strong legal support for unions. (Note: In some countries like France, non-union workers still have their wages determined by union negotiations).
D. Apologists for European labor marker were quick to note that in March 2009, U.S. unemployment surpassed Europe's. But:
    1. This was only a blip. European unemployment is once again more than 2 percentage-points worse than ours.
    2. You should *expect* more flexible labor markets to respond more rapidly to negative shocks. The key question is long-run performance.

FIGURE 2
Unemployment Rate in the United States and EU-15, 1993-2009

Source: Eurostat (2009).

E. What happened since? What you'd expect. U.S. has recovered, EU has not. And European exceptions have relatively free labor markets.



VIII. Occupational Licensing

A. Most econ textbooks discuss labor unions at length, but at least in the United States, occupational licensing is much more important.
   1. Almost 30% of American workers now need a license to legally do their jobs. Only about 12% belong to unions – and more than half of them are government employees.

B. Licensing clearly raises the wages of licensed workers; they make about 15% more than you'd otherwise expect. (Roughly as big a bonus as unionized workers get).

C. People often claim that occupational licensing raises quality and protects the public, but:
   1. For many licensed occupations – barber, interior decorator, athletic trainer – this argument fails the laugh test.
   2. The average study of the effect of licensing on quality finds a moderately *negative* effect on quality. (Not so surprising: Licensing inhibits innovation).
   3. Higher quality is often not worth the extra price. Markets (or government *certification*!) let consumers decide for themselves. Licensing makes everyone pay full price.

D. Unregulated markets have simple mechanisms to ensure quality:
   1. Reputation
   2. Guarantees
   3. Lawsuits (much less important, but a useful last resort)

E. We already heavily rely on these mechanisms – see eBay and Amazon Marketplace. Why can't we rely on them in labor markets?

F. Medical licensing: Is this really such a hard case after all?
   1. Medical licensing clearly raises medical prices.

        2. *Many* medical tasks now performed by doctors could easily be performed by less-trained (and cheaper) workers. The same goes for other medical professionals.
        3. HMOs and insurance companies make reputation work much effective than you'd initially think.

IX. Regulation Under Slavery
    A. A great deal of supposedly "pro-labor" regulation is actually counter-productive. Would the same hold under slavery?
    B. For the most part, no. Under slavery, the popular intuition turns out to be exactly correct.
    C. Example #1: A minimum wage for slaves. If enforced, this means that slaves get more than subsistence. At the same time, it decreases the demand for slaves, which reduces the incentive to hunt for additional slaves.
    D. Example #2: Worker health and safety regulation for slaves. Due to regulation, slaves have more safety and health, and still receive the same subsistence earning they would have gotten anyway. This also reduces the demand for slaves, which hurts the slave trade.
    E. Example #3: Banning or regulating the punishments that owners can inflict on slaves.
    F. Example #4: Boycotting products of slave labor.
    G. With sufficiently strict regulation, slave-owners will want to free their slaves! Thus, the "Why not a minimum wage of $1,000,000?" argument can be easily answered under slavery: "The higher the better."

X. Slavery and "Wage Slavery" Compared
    A. Socialists and defenders of slavery alike have frequently derided free labor markets as "wage slavery," equating the condition of slaves and free laborers.
    B. This had cache in the emerging industrial economies like the U.S. and Britain in the 19th century. (E.g. Dickens) It remains a popular way of thinking about life for workers in the Third World.
    C. As workers - free or slave - become more productive, labor demand rises. The difference:
        1. Free laborers capture the benefits of rising labor productivity for themselves.
        2. Under slavery, in contrast, it is slave-owners who capture the benefits of rising labor productivity. Slave-owners don't have to worry that slaves will leave them for a better-paying offer.
    D. Free workers also get to make their own trade-off between income and safety and comfort. When a master decides to send his slave to mine diamonds, he only maximizes his expected income. A free worker makes a trade-off between expected income and safety and comfort.
    E. The toned-down version of the "wage slavery" story is that free workers are "exploited." It is easy to see how slaves are exploited:

They get less than their free market wage. In what sense are free workers exploited?

F. Ex: Western observers look at "sweatshops" in poor countries and cry "exploitation." This is both false and harmful for Third World workers:
   1. False: Investing in the Third World is not especially profitable; otherwise everyone would do it. (How much do *you* invest in the Third World?)
   2. Harmful: If boycotts reduce the demand for Third World products, labor demand for Third World labor falls.

XI. Why the Standard History of Labor Is Wrong

A. Most history books tell a story something like this:
   1. In the days before the minimum wage, unions, etc., life was terrible for workers because employers paid them whatever they felt like paying them.
   2. But then government became more progressive, and changed the laws.
   3. Life is now better for workers because employers' greed has been tamed.

B. This makes no sense at all. Why?

C. Employers compete with other employers; they care about their own profits, not the profits of employers in general. Workers have always earned their marginal productivity.

D. Why then were workers paid less in the past? Their marginal productivity was lower! As technology progressed, the marginal productivity of workers increased, and labor demand accordingly went up.

E. Suppose government had imposed strict regulations when productivity was low? The result would have been higher wages for the lucky, but permanent unemployment (and probably starvation) for the rest.

F. The problem of workers in the Third World isn't lack of regulation, but low productivity. Of course, low productivity can be a product of a crummy political system, but you can't solve that problem with labor market regulation.