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Econ 309

## **Weeks 6-7: Labor Market Regulation**

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- I. The Basics of Labor Demand and Labor Supply
  - A. If firms maximize profits, labor demand depends entirely on worker productivity. If an extra worker brings \$50,000 into your business, you'll pay up to \$50,000 to get him. If he only brings \$500, you'll pay up to \$500 to get him.
  - B. SDB makes it hard to publicly admit this truth, but it's obvious. Tom Cruise makes \$30M a movie because Tom Cruise brings in millions of extra customers. The extras in the scene behind him make very little because they bring in almost no extra customers.
  - C. Labor supply, in contrast, depends on:
    1. Scarcity of skill
    2. Pleasantness or unpleasantness of the job
  - D. Obvious? Yes. The implications, however, strongly violate SDB. So people officially deny them, and policy often reflects popular denial.
- II. 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 voluntary (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 involuntary 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. 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.
  - G. The general solution to all involuntary unemployment boils down to: reduce the market wage until the surplus disappears.
- III. Government Policy in the Real World, I: The Minimum Wage
  - A. If markets are slow to adjust, government could try to *force* wages down! They rarely do.

- B. Instead, governments around the world deliberately push wages *up* and prevent market adjustment.
  - C. Classic case: 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. In the U.S., the federal minimum wage itself is fairly low (about 1% of the U.S. workforce earns it). In other countries like France, the minimum wage affects a large percentage of the workforce.
- IV. Government Policy in the Real World, II: 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. CBA of labor regulation.
- V. 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.
    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?)

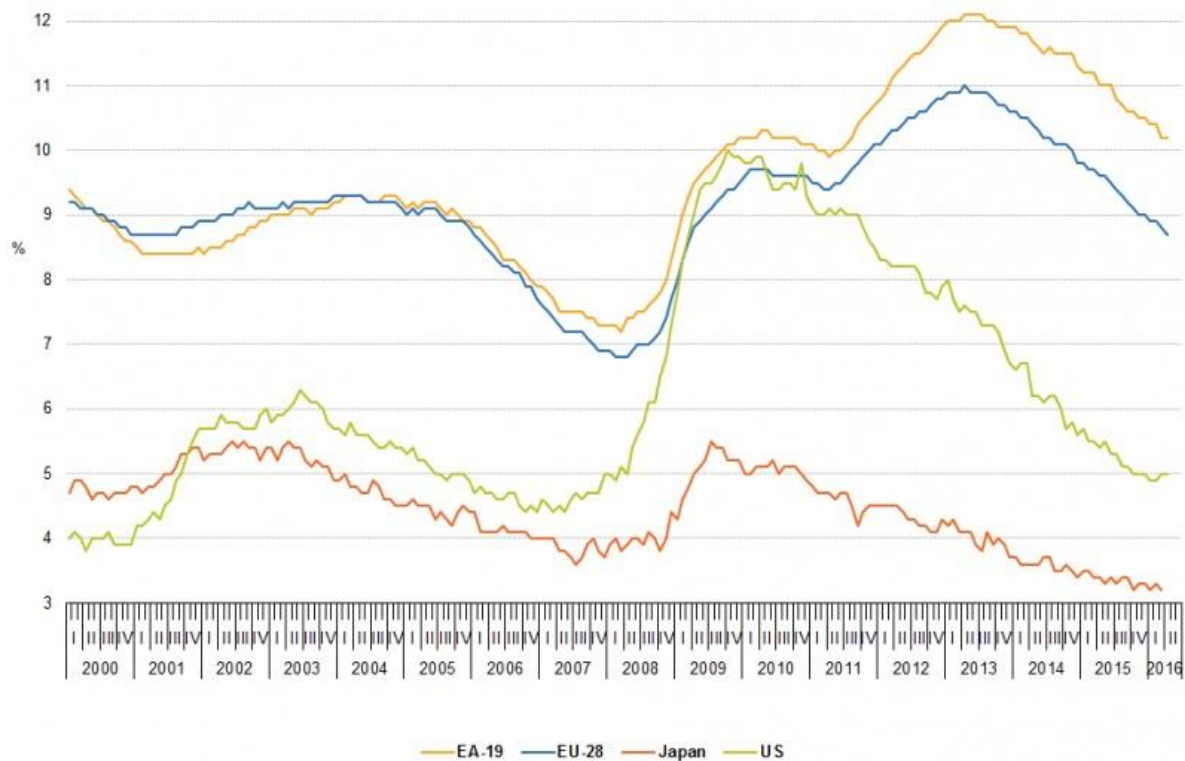
5. High unionization rates with strong legal support for unions.  
(Note: In some countries like France, non-union workers still have their wages determined by union negotiations).
- D. Apologists for European labor market were quick to note that in March 2009, U.S. unemployment surpassed Europe's. But:
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.



## VI. 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.
  - G. CBA of occupational licensing.
- VII. Why the Standard History of Labor Is Wrong
- E. 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.
  - F. This makes no sense at all. Why?
  - G. 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.
  - H. 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.
  - I. 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.
  - J. 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.
- XI. Wage *Differences* versus Wage *Discrimination*
- A. People don't earn the same income, and neither do groups. There are, on average, large wage differences.
  - B. From the NLSY (1992 data): Average annual labor income was \$17,100. Compared to white males, what did members of other groups earn on average?

Group	Labor Income Gap
Black	-\$6200
Other Non-White	-\$3700
Female	-\$12,000

- C. No one disputes that there are large wage differences. The debate, rather, is about *why*. Are these gaps partly or wholly explained by the fact that groups differ in average characteristics relevant to marginal productivity?
- D. Two kinds of characteristics: the ones we measure (or "observe") like education and IQ, and the ones we don't, like culture and creativity. Can wage differences be explained by differences in observable characteristics?
- E. Let's start with an easy one. What if we control for marital status and number of children? A lot of women have no labor income because they don't work and/or don't work as much because they take care of kids.
- F. Suppose we compare never-married, childless males and females? The -\$12,000 gap shrinks to a mere -\$1,100 gap! It's not even "statistically significant" as econometricians say.
- G. Now let's move to something harder. Is there any way to account for racial income differences? Let's start by controlling only for education and experience. What then?
- H. The "other non-white" gap essentially disappears, but the white-black gap only mildly shrinks.

Group	Labor Income Gap
Black	-\$5300
Other Non-White	-\$700

- I. What if we also control for measured intelligence? (The NLSY administered extensive intelligence tests to people surveyed).
- J. Other non-whites actually earn *more* than observably identical whites; the white-black gap drastically shrinks.

Group	Labor Income Gap
Black	-\$2300
Other Non-White	+\$1100

- K. Many scholars who have studied black poverty have put some blame on differences in family structure. On average, blacks are much less likely to marry and remain married; yet blacks on average have more children. What if we add in controls for family variables?
- L. Remaining black-white gap shrinks still further, becoming statistically insignificant. Other non-whites look even better off than before.

Group	Labor Income Gap
Black	-\$900
Other Non-White	+\$1700

- M. There are definitely large differences in labor earnings, and they match the popular stereotypes about which groups the market treats "unfairly."
- N. But it is wrong to infer discrimination from inequality. You must control for real group differences first.

- O. Once you do so, there is little evidence of discrimination. (And some of it cuts the wrong way!) Labor income differs between groups because - on average - groups differ in education, intelligence, family structure, etc.
- XII. Discrimination as a Preference
- A. We have seen that the empirical case for discrimination is weak.
  - B. Interestingly, many economists doubted - on *theoretical* grounds - that discrimination had much effect long before much data was available.
  - C. Why? Let us begin by defining "discrimination" more precisely. In economic terms, we can think of pure dislike or hatred for others as a *taste for discrimination*, a willingness to pay to avoid people you don't like.
  - D. For example, suppose a Serbian employer hates Croatians. But how much is he willing to pay for this? Would he give up \$1,000,000 to avoid hiring a Croatian? Probably not. There is some amount of money sufficient to make the Serbian hire the Croatian in spite of his discriminatory taste.
- XIII. Discrimination by Employers
- A. Once we understand this notion of the "taste for discrimination," we can use it to analyze employer-on-worker discrimination.
  - B. Assumptions:
    1. Most employers have a taste for discrimination against Asians. Their willingness to pay to satisfy this taste ranges from \$2/hour/worker to \$0/hour/worker, with an average of \$1/hour/worker.
    2. No one else has discriminatory tastes.
    3. Asian and non-Asian workers are equally productive.
    4. Labor markets are competitive and there are no anti-discrimination laws.
  - C. What happens? Labor demand for Asians is lower and they earn lower wages - at first.
  - D. Who hires them? The **least-discriminatory** employers! If the wage gap is \$1.00, then employers who value discrimination by less than \$1.00 hire only Asians.
  - E. More racism thus means lower profits. Less racist employers hire cheaper Asian labor, while more racist employers higher more expensive non-Asian labor.
  - F. Thus, over time the most racially tolerant employers become a larger and larger part of the market, and racist employers are driven out of business.
  - G. This shifts employers' distribution of discriminatory tastes in the direction of tolerance - raising the demand for Asian labor and reducing the demand for non-Asian labor. So the wage gap falls.
  - H. As long as there are enough employers who care solely about money, not race, the ultimate effect is that racist employers are

driven from the market, and equally-productive labor earns the same wage.

- I. Even if most people are racist, selective pressure favors non-racist employers. Businesspeople are competing to make money; any goals other than making money - good or bad - hold them back.
  - J. In other words, more greedy, less racist employers tend to drive less greedy, more racist employers out of business.
  - K. Corollary 1: Government regulation is necessary to **sustain** discrimination by profit-seeking employers.
  - L. Corollary 2: Discrimination is much more likely to appear in the *non-profit* sector.
- XIV. Stereotypes and Information Economics
- A. Gathering more information takes time, and time is foregone income. Thus, people inevitably - and sensibly - quit gathering information once they think their understanding is "good *enough*."
  - B. Of course, "mistakes will be made." People are choosing between two evils - wrong judgments and lost time.
  - C. This is the essence of stereotyping: Generalizing in a useful but fallible way based on limited information.
  - D. People use stereotypes all of the time. You probably assumed I was the professor the first time you saw me in class. Why? Because I fit the stereotypical age of a professor. Were you irrational to use this stereotype? Hardly.
  - E. What would your day be like if you used no stereotypes? You use stereotypes about traffic patterns to choose your route to school. You use stereotypes about campus police to decide whether to illegally park. You use stereotypes about couples to guess whether two people are married.
  - F. Many people think stereotypes are plainly false. But it's an empirical question. This is a huge topic, but there is a lot of evidence that most stereotypes are right on average most of the time.
  - G. Moreover, people who don't like stereotypes still use them. "Police are bigots" is a stereotype. "White people make more money than black people" is a stereotype. Both may be true on average, but they are stereotypes nevertheless.
  - H. Not sure? Test your own stereotypes against objective statistics.
  - I. The basic stereotype fallacy: Confusing averages and universals. But does anyone actually do this?
- XV. Statistical Discrimination
- A. Suppose employers rely on a stereotype to make employment decisions, and that stereotype is true on average.
  - B. Is that "discrimination"? In a sense, yes - you are being judged for your group, not yourself. But in another sense, no - the group differences are real, and people don't *dislike* your group as such. Economists call this *statistical discrimination*.



- C. A good example: gender and auto insurance premiums.
  - D. Another example: who cabbies will pick up late at night.
  - E. Unlike taste-based discrimination, statistical discrimination can survive and thrive in markets. If group differences are real, and it is costly to judge case-by-case, then people who *don't* discriminate lose money.
  - F. Important point: Statistical discrimination does **not** reduce *mean* group income. It just narrows the distribution. People who exceed their group stereotype's performance level are under-paid; people who fall short of their group stereotype's performance level are over-paid.
- XVI. The Effect of Discrimination Laws
- A. Suppose, once again, that discrimination is a pure taste. What do anti-discrimination laws accomplish?
  - B. If they correctly identify discrimination, then very little. Markets already severely punish employers who pay more for workers than necessary.
    - 1. They might however exacerbate worker-on-worker discrimination by forbidding segregation.
  - C. However, if "discrimination" laws blur the line between "difference" and "discrimination," effects can be severe. The law then effectively requires employers to pay workers of different ability levels the same; employers respond by preferring the more productive group, making life even harder for the less productive group.
  - D. In other words, discrimination laws act as a price control, requiring equal wages in two labor markets where the market clears at different wage levels.
  - E. To some extent, though, discrimination laws might be seen as quantity restrictions (hire  $x$  workers of group  $y$  or else!). The short-run effect of this on group  $y$  can be positive; but in the longer-run employers figure out ways to avoid this burden.
    - 1. E.g. Relocate the firm to states with small "protected" populations.
  - F. For statistical discrimination, discrimination laws have the same negative effects. Groups are really different on average, but the law says employers must treat them the same. Firms then do their best to avoid paying people more than they're worth.
  - G. Ex: How might unregulated markets induce cab-drivers to pick up late at night in dangerous areas?
  - H. Similarly, able members of low-productivity groups might - in an unregulated market - agree to work for free on a temporary basis to prove themselves. This would probably be illegal under current law.
- XVII. Discrimination Laws In Practice

- A. Under the discrimination laws, aggrieved individuals can sue employers for discriminating against them.
  - B. Employers can defend themselves by showing that the worker was judged on the basis of individual performance.
  - C. Still, the defense always labors under the equivocation between difference and discrimination.
  - D. Interestingly, most discrimination suits come from workers who say their current employer mistreated them, **not** from workers who say they were not hired in the first place.
    - 1. The irony is that an employer who was actually racist, or simply wanted to avoid legal headaches, is probably less likely to be sued than someone who gives individuals a chance.
  - E. If employers practice statistical discrimination, why would they want to fire a worker after hiring him? Only if he is below his group mean!
  - F. CBA of discrimination laws.
- XVIII. Why the Standard History of Discrimination Is Wrong
- A. The standard story: White males arbitrarily discriminated against everyone else out of pure malice. Then activists "raised awareness" and discrimination laws were passed to open up opportunities for people other than white males. While a strong legacy of racism and sexism persists, these laws have created the progress that disadvantaged groups have enjoyed since 1965.
  - B. Why it's wrong:
    - 1. Even if average levels of malice were high, employers are among the least racist people around. They are selected to care about profits, not skin color.
    - 2. White males have earned more money on average, but most or all of that difference disappears controlling for characteristics.
    - 3. Blacks and other groups were enjoying rapid economic progress long before any civil rights acts were passed. Asians already equaled or exceeded white income - even Japanese-Americans, who lost most of their wealth during WWII internment.
    - 4. Lower-earning groups enjoyed progress before the civil rights laws in large part because their average characteristics were changing. Blacks were acquiring more education and skills, immigrants were acquiring language fluency, women were changing their family plans, and so on.
    - 5. Most of the progress that non-white-males have enjoyed has been inevitable. On net, civil rights laws may have impeded their progress by making employers reluctant to hire people who might potentially sue them.