

Labor Economics

GEORGE J. BORJAS



LABOR ECONOMICS

George J. Borjas

John F. Kennedy School of Government
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**To My Children,
Sarah, Timothy, and Rebecca**

PREFACE

The seventeenth-century Japanese novelist Ihara Saikaku wrote that “the first consideration of all, throughout life, is the earning of a living.” This fact has motivated many economists to understand how labor markets work; why some persons choose to work, while other persons withdraw from the labor market; why some firms expand their employment at the same time that other firms are laying off workers; and why earnings are distributed unequally in most societies.

This book differs from other textbooks in labor economics mainly in its philosophy. I believe that knowing the *story* of how labor markets work is, in the end, more important than “showing off” our skills at constructing elegant models of the labor market or our skills at remembering hundreds of statistics that summarize labor market conditions at a particular point in time. I doubt that many students will (or should!) remember the mechanics of deriving a labor supply curve or the way that the unemployment rate is officially calculated 5 or 10 years after they leave college. If students can remember the *story* of the way the labor market works, however, they will be much better prepared to make informed opinions about such proposed government policies as a “workfare” program requiring that welfare recipients work, or a payroll tax assessed on employers to fund a national health care program. The exposition in this book, therefore, stresses the *ideas* that economists use to understand how the labor market works.

Although the book makes extensive use of labor market statistics, these data provide the “scenery” for our story. The data summarize the stylized facts that a good theory of the labor market should explain, as well as help shape our thinking about the way the labor market works. The main objective of the book, therefore, is to survey the field of labor economics with an emphasis on *both* theory and facts. As a result, the book relies much more heavily on “the economic way of thinking” than other existing textbooks do. I believe this approach gives a better understanding of what labor economics is about than an approach which minimizes the story-telling aspects of economic theory.

PREREQUISITES

Although this book uses economic analysis throughout the discussion, *all* the theoretical tools are introduced and explained. I only require that the student has been exposed to a course in the principles of microeconomics, particularly supply and demand curves. All other concepts (such as indifference curves, budget lines, production functions, and isoquants) are defined and explained when they first appear in our story. The book does not make use of any mathematical skills beyond those taught in high school algebra

(particularly, the notion of a slope). Finally, labor economists make extensive use of econometric analysis in their research. Although the discussion in this book does not require any prior exposure to econometrics, students will get a much better “feel” for the research findings if they know a little about how labor economists manipulate data to reach their conclusions. The appendix to Chapter 1 provides a simple (and very brief) introduction to econometrics, and allows the student to visualize how labor economists conclude, for instance, that wealth reduces labor supply, or that schooling increases earnings.

ORGANIZATION OF THE BOOK

The book begins with a tour of labor supply. Chapter 2 presents the static theory of labor supply (how workers allocate their time at a point in time), whereas Chapter 3 extends the basic model to analyze how workers allocate their time over time. The book then turns to a discussion of labor demand in Chapter 4. Chapter 5 puts together the supply decisions of workers with the demand decisions of employers and shows how the market “balances out” the conflicting interests of the two parties.

The remainder of the book extends and generalizes the basic supply-demand framework. Chapter 6 stresses that jobs differ in their characteristics, so that jobs which offer unpleasant working conditions may have to offer higher wages in order to attract workers. Chapters 7 and 8 stress that workers are different, either because they differ in their educational attainment (Chapter 7), or because they differ in the volume of on-the-job training they acquire (Chapter 8). These human capital investments help determine the economy’s wage distribution. Chapter 9 describes a key mechanism that allows the labor market to balance out the interests of workers and firms, namely labor turnover and migration.

The final chapters of the book discuss a number of distortions and imperfections in labor markets. Chapter 10 analyzes how labor market discrimination affects the earnings and employment opportunities of minority workers and women. Chapter 11 discusses how labor unions affect the relationship between the firm and the worker. Chapter 12 notes that employers often find it difficult to monitor the activities of their workers, so that the workers will want to “shirk” on the job. The chapter discusses how different types of labor market contracts arise to discourage workers from misbehaving. Finally, Chapter 13 discusses how unemployment can arise and persist in labor markets.

The text uses a number of pedagogical devices designed to deepen the student’s understanding of labor economics. A chapter typically begins by presenting a number of stylized facts about the labor market, such as wage differentials between blacks and whites or between men and women. Each chapter then presents the story or theory that labor economists have developed to understand why these facts are observed in the labor market and then extends and applies the theory to other labor market phenomena. Each chapter typically contains at least one lengthy application of the material to a major policy issue, as well as presents a number of boxed examples showing the “Theory at Work.”

The end-of-chapter material also uses a number of “student-friendly” devices: a chapter summary briefly describing the main lessons of the chapter and a “Key Concepts” section listing the major concepts introduced in the chapter (when a key concept makes its first appearance, it appears in **boldface**). Each chapter also includes “Summary Questions” that the student can use to review the major theoretical and empirical issues. The chapter then ends with a set of problems that test the student’s understanding of the material.

ACKNOWLEDGMENTS

I was extremely fortunate to have learned labor economics from Gary Becker, James Heckman, Jacob Mincer, and Sherwin Rosen. I was greatly influenced by their belief that the study of labor economics can help us understand how “real-world” labor markets work. Their influence, I believe, is evident on every page of this book. I have also benefited greatly from a long professional and personal friendship with Richard Freeman. His approach to “doing” labor economics has had an important impact on my work.

I have learned a great deal from the generations of undergraduate students who have been exposed to various versions of the material contained in this book throughout the past decade. Each generation of students left its mark on the material. The searching questions (and blank stares) of the undergraduates motivated me to search for clearer and more direct examples of the points that I was trying to make.

I am grateful for the very able research assistance of Jeffrey Russell and Lynette Hilton. They prepared the graphs, checked out the problems, reviewed many drafts of each of the chapters, and made numerous comments that improved the exposition of the material.

I have also benefited from the comments made by many colleagues at various institutions. These colleagues include Steven Allen, North Carolina State University; Neil Alper, Northeastern University; Julian Betts, University of California, San Diego; Bernt Bratsberg, Kansas State University; Janet Currie, University of California, Los Angeles; Robert Gitter, Ohio Wesleyan University; Matthew Goldberg, Institute for Defense Analysis; Shoshana Grossbard-Shechtman, San Diego State University; James Henderson, Baylor University; Lawrence Kenny, University of Florida; Mark Killingsworth, Rutgers University; Kenneth McLaughlin, Hunter College; Kathryn Nantz, Fairfield University; Eric Solberg, California State University–Fullerton; and Stephen Trejo, University of California, Santa Barbara.

Finally, I would like to thank my mother, Edita, for encouraging my investments in human capital; my wife, Jane, for her support during the years I was preparing this book; and my children, Sarah, Timothy, and Rebecca, for continuously reminding me of the things that are truly important in life.

George J. Borjas

CONTENTS IN BRIEF

PREFACE	xvii
1 Introduction	1
2 Labor Supply: Theory and Evidence	17
3 Labor Supply over Time	71
4 Labor Demand	101
5 Labor Market Equilibrium	152
6 Compensating Wage Differentials	188
7 Human Capital: Education and Earnings	220
8 Human Capital: On-the-Job Training and the Wage Structure	250
9 Labor Mobility	279
10 Labor Market Discrimination	318
11 Trade Unions	358
12 Labor Market Contracts and Work Incentives	401
13 Unemployment	434
INDEXES	471

CONTENTS

PREFACE	xvii
1 Introduction	1
1-1 AN ECONOMIC STORY OF THE LABOR MARKET	2
1-2 THE ACTORS IN THE LABOR MARKET	3
1-3 WHY DO WE NEED A THEORY?	5
1-4 THE ORGANIZATION OF THE BOOK	7
Summary	8
Key Concepts	8
Review Questions	8
Appendix: An Introduction to Regression Analysis	9
2 Labor Supply: Theory and Evidence	17
2-1 MEASURING THE LABOR FORCE	18
2-2 SOME STYLIZED FACTS ABOUT LABOR SUPPLY	20
2-3 THE WORKER'S PREFERENCES	23
2-4 THE TIME AND BUDGET CONSTRAINTS	28
2-5 TO WORK OR NOT TO WORK?	30
2-6 THE HOURS OF WORK DECISION	33
2-7 POLICY APPLICATION: WELFARE PROGRAMS AND WORK INCENTIVES	46
2-8 THE NONMARKET SECTOR	51
2-9 ESTIMATES OF THE LABOR SUPPLY ELASTICITY	58
2-10 LABOR SUPPLY OF WOMEN	64
Summary	68
Key Concepts	68
Review Questions	69
Problems	69
3 Labor Supply over Time	71
3-1 LABOR SUPPLY OVER THE LIFE CYCLE	72
3-2 LABOR SUPPLY OVER THE BUSINESS CYCLE	81
3-3 RETIREMENT	83
3-4 POLICY APPLICATION: THE DECLINE IN WORK ATTACHMENT AMONG OLDER WORKERS	87
3-5 FERTILITY	92
	xi

Summary	98
Key Concepts	99
Review Questions	99
Problems	99
4 Labor Demand	101
4-1 THE PRODUCTION FUNCTION	102
4-2 THE EMPLOYMENT DECISION IN THE SHORT RUN	105
4-3 THE EMPLOYMENT DECISION IN THE LONG RUN	111
4-4 THE LONG-RUN DEMAND CURVE FOR LABOR	116
4-5 THE ELASTICITY OF SUBSTITUTION	123
4-6 MARSHALL'S RULES OF DERIVED DEMAND	125
4-7 SUBSTITUTES AND COMPLEMENTS	127
4-8 AN OVERVIEW OF LABOR MARKET EQUILIBRIUM	130
4-9 THE CROSS-ELASTICITY OF FACTOR PRICE	132
4-10 POLICY APPLICATION: THE IMPACT OF IMMIGRANTS ON THE WAGE OF NATIVES	133
4-11 ADJUSTMENT COSTS AND LABOR DEMAND	138
4-12 THE DISTINCTION BETWEEN WORKERS AND HOURS	144
Summary	147
Key Concepts	148
Review Questions	148
Problems	149
Appendix: The Long-Run Labor Demand Curve When Labor Is an Inferior Input	150
5 Labor Market Equilibrium	152
5-1 EQUILIBRIUM IN A SINGLE COMPETITIVE LABOR MARKET	153
5-2 COMPETITIVE EQUILIBRIUM ACROSS LABOR MARKETS	154
5-3 POLICY APPLICATION: PAYROLL TAXES	158
5-4 THE COBWEB MODEL	162
5-5 POLICY APPLICATION: THE IMPACT OF MINIMUM WAGES	165
5-6 NONCOMPETITIVE LABOR MARKETS: MONOPSONY	174
5-7 NONCOMPETITIVE LABOR MARKETS: MONOPOLY	180
5-8 WAGES AND EMPLOYMENT IN THE PUBLIC SECTOR	183
Summary	185
Key Concepts	185
Review Questions	186
Problems	186
6 Compensating Wage Differentials	188
6-1 THE WORKER'S SUPPLY TO RISKY JOBS	189
6-2 THE FIRM'S DECISION TO OFFER A RISKY ENVIRONMENT	195
6-3 MARKET EQUILIBRIUM	199
6-4 THE HEDONIC WAGE FUNCTION	202
6-5 POLICY APPLICATION: HOW MUCH IS A LIFE WORTH?	206

6-6	POLICY APPLICATION: THE IMPACT OF HEALTH AND SAFETY REGULATIONS	208
6-7	COMPENSATING DIFFERENTIALS AND JOB AMENITIES	211
6-8	COMPENSATING DIFFERENTIALS AND LAYOFFS	213
	Summary	217
	Key Concepts	218
	Review Questions	218
	Problems	218
7	Human Capital: Education and Earnings	220
7-1	EDUCATION IN THE LABOR MARKET: SOME STYLIZED FACTS	221
7-2	THE SCHOOLING MODEL	222
7-3	THE WAGE GAP AMONG WORKERS WHO DIFFER IN THEIR EDUCATION	229
7-4	POLICY APPLICATION: ESTIMATES OF THE RATE OF RETURN TO SCHOOLING	234
7-5	DO STUDENTS CHOOSE THE SCHOOLING THAT MAXIMIZES LIFETIME EARNINGS?	238
7-6	SCHOOLING AS A SIGNAL	241
	Summary	247
	Key Concepts	247
	Review Questions	248
	Problems	248
8	Human Capital: On-the-Job Training and the Wage Structure	250
8-1	AGE-EARNINGS PROFILES	251
8-2	POST-SCHOOL HUMAN CAPITAL INVESTMENTS	252
8-3	ON-THE-JOB TRAINING AND THE AGE-EARNINGS PROFILE	257
8-4	POLICY APPLICATION: EVALUATION OF GOVERNMENT TRAINING PROGRAMS	264
8-5	THE EARNINGS DISTRIBUTION	267
8-6	POLICY APPLICATION: WHAT HAPPENED TO THE WAGE STRUCTURE IN THE 1980s?	272
	Summary	276
	Key Concepts	277
	Review Questions	277
	Problems	277
9	Labor Mobility	279
9-1	GEOGRAPHIC MIGRATION AS A HUMAN CAPITAL INVESTMENT	280
9-2	INTERNAL MIGRATION IN THE UNITED STATES	281
9-3	FAMILY MIGRATION	284
9-4	IMMIGRATION IN THE UNITED STATES	287
9-5	POLICY APPLICATION: IMMIGRANT PERFORMANCE IN THE U.S. LABOR MARKET	288

9-6	THE DECISION TO IMMIGRATE	295
9-7	POLICY APPLICATION: THE ECONOMIC BENEFITS FROM IMMIGRATION	300
9-8	JOB TURNOVER: SOME STYLIZED FACTS	303
9-9	THE JOB MATCH	305
9-10	THE EFFICIENT TURNOVER HYPOTHESIS	306
9-11	STATE DEPENDENCE AND HETEROGENEITY	308
9-12	JOB TURNOVER AND EARNINGS	311
	Summary	314
	Key Concepts	315
	Review Questions	316
	Problems	316
10	Labor Market Discrimination	318
10-1	RACE AND GENDER IN THE LABOR MARKET	319
10-2	THE DISCRIMINATION COEFFICIENT	320
10-3	EMPLOYER DISCRIMINATION	321
10-4	EMPLOYEE DISCRIMINATION	330
10-5	CONSUMER DISCRIMINATION	331
10-6	STATISTICAL DISCRIMINATION	332
10-7	MEASURING DISCRIMINATION	336
10-8	POLICY APPLICATION: EMPIRICAL EVIDENCE ON RACIAL DISCRIMINATION	340
10-9	POLICY APPLICATION: EMPIRICAL EVIDENCE ON GENDER DISCRIMINATION	346
10-10	DISCRIMINATION AGAINST OTHER GROUPS	353
	Summary	355
	Key Concepts	356
	Review Questions	356
	Problems	356
11	Trade Unions	358
11-1	UNIONS IN THE UNITED STATES	359
11-2	DETERMINANTS OF UNION MEMBERSHIP	363
11-3	WHAT DO UNIONS WANT?	369
11-4	MONOPOLY UNIONS	371
11-5	EFFICIENT CONTRACTS	372
11-6	STRIKES	378
11-7	UNION WAGE EFFECTS	384
11-8	THE EXIT-VOICE HYPOTHESIS	390
11-9	UNION BEHAVIOR IN THE PUBLIC SECTOR	392
11-10	POLICY APPLICATION: UNIONS AND RESOURCE ALLOCATION	395
	Summary	397
	Key Concepts	398
	Review Questions	398
	Problems	399

12	Labor Market Contracts and Work Incentives	401
12-1	PIECE RATES AND TIME RATES	402
12-2	TOURNAMENTS	408
12-3	POLICY APPLICATION: THE COMPENSATION OF EXECUTIVES	414
12-4	WORK INCENTIVES AND UPWARD-SLOPING AGE-EARNINGS PROFILES	417
12-5	EFFICIENCY WAGES	421
	Summary	431
	Key Concepts	432
	Review Questions	432
	Problems	433
13	Unemployment	434
13-1	UNEMPLOYMENT IN THE UNITED STATES	435
13-2	FRICTIONAL AND STRUCTURAL UNEMPLOYMENT	439
13-3	THE STEADY-STATE RATE OF UNEMPLOYMENT	441
13-4	JOB SEARCH	445
13-5	POLICY APPLICATION: UNEMPLOYMENT COMPENSATION	451
13-6	THE INTERTEMPORAL SUBSTITUTION HYPOTHESIS	455
13-7	THE SECTORAL SHIFTS HYPOTHESIS	457
13-8	EFFICIENCY WAGES	458
13-9	POLICY APPLICATION: THE TRADE-OFF BETWEEN INFLATION AND UNEMPLOYMENT	462
	Summary	467
	Key Concepts	468
	Review Questions	468
	Problems	468
	INDEXES	
	Name Index	471
	Subject Index	479

1

INTRODUCTION

Science is built up with facts, as a house is with stones. But a collection of facts is no more a science than a heap of stones is a house.

—Jules Henri Poincaré

Most of us will allocate a substantial fraction of our time to the labor market. How we do in the labor market helps determine our wealth, the types of goods we can afford to consume, who we associate with, where we vacation, which schools our children attend, and even the types of persons who find us attractive. As a result, we are all eager to learn how the labor market works. **Labor economics** studies *how* labor markets work.

Our deep interest in labor markets arises not only from our own personal involvement, but also because many of the issues in the debate over social policy concern the labor market experiences of particular groups of workers, or question various aspects of the employment relationship between workers and firms. Among the policy issues examined by modern labor economics are:

- 1 Why did the labor force participation of women rise steadily throughout the past century?
- 2 Do welfare programs create work disincentives?
- 3 What is the impact of immigration on the wage and employment opportunities of native-born workers?
- 4 Do minimum wages increase the unemployment rate of less-skilled workers?
- 5 What is the rate of return to schooling, and how does it compare to the rate of return on other investments?
- 6 Why did wage inequality increase rapidly in the 1980s?
- 7 What is the impact of affirmative action programs on the earnings of women and minorities?
- 8 Do unions increase the wages of their members, and by how much?
- 9 Are the seemingly extravagant salaries paid to executives in large U.S. corporations related to firm performance?
- 10 Why is unemployment a pervasive characteristic of modern labor markets?

This diverse list of questions clearly illustrates why the study of labor markets is intrinsically more important and more interesting than the study of the market for butter (unless one happens to be in the butter business!). Labor economics helps us understand and address many of the social and economic problems facing modern societies.

1-1 AN ECONOMIC STORY OF THE LABOR MARKET

This book tells the “story” of how labor markets work. Telling this story involves much more than simply recounting the history of labor law in the United States and other countries, or presenting tables of statistics summarizing conditions in the labor market. After all, good stories have themes, characters that come alive with vivid personalities, conflicts that have to be resolved, ground rules that limit the set of permissible actions, and events that result inevitably from the interaction among these characters.

The story we will tell about the labor market contains all these features. Labor economists typically assign motives to the various “actors” in the labor market. We typically view workers, for instance, as trying to find the best possible job and assume that firms are trying to make money. We then follow these persons and organizations as they meet, interact, and make exchanges in the labor market. These exchanges determine the types of jobs that are offered, the skills that workers acquire, the extent of labor turnover, the structure of unemployment in the economy, and the observed earnings distribution. The story thus provides a theory, a framework for understanding, analyzing, and predicting a wide array of labor market outcomes.

The underlying philosophy of the book is that modern economics provides a useful story of how the labor market works. In particular, the typical assumptions we make about the behavior of workers and firms, and about the ground rules under which the labor market participants make exchanges, lead to outcomes that often mirror the facts observed in “real-world” labor markets. Labor economics, therefore, helps us understand and predict why some labor market outcomes are more likely to be observed than others.

The discussion is also guided by the belief that learning the story of how labor markets work is as important as knowing basic facts about the labor market. Without understanding how labor markets work—that is, without having a theory of why workers and firms pursue some employment relationships and avoid others—we would be hard pressed to predict the labor market impact of changes in government policies or of changes in the demographic composition of the labor force. Put differently, the study of facts without theory is just as empty as the study of theory without facts.

The question is often asked as to which are more important, ideas or facts? The analysis presented throughout the book stresses a famous philosopher’s insight that “ideas *about* facts” are most important.¹ We do not study labor economics so that we can construct elegant theories of the labor market, or so that we can remember how the official unemployment rate is calculated and that the unemployment rate was 6.8 percent in 1993. Rather, we want to understand which economic and social factors generate this level of unemployment, and why.

¹This reply was given by the English philosopher Alfred North Whitehead.

The main objective of the book, therefore, is to survey the field of labor economics with an emphasis on *both* theory and facts: where the theory helps us understand how the facts are generated; and where the facts can help shape our thinking about the way labor markets work.

1-2 THE ACTORS IN THE LABOR MARKET

Throughout the book, we will see that there are three leading actors in the labor market: workers, firms, and the government.

As workers, we receive top casting in the story. Without us, after all, there is no “labor” in the labor market. We decide whether to work or not, how many hours to work, which skills to acquire, when to quit a job, which occupations to enter, whether to join a labor union, and how much effort to allocate to the job. Each of these decisions is motivated by the desire to *optimize*, to choose the best available option from the various choices. Workers in our story, therefore, will act in ways that maximize their well-being, which we will call **utility**. Adding up the decisions of millions of workers generates the economy’s **labor supply** not only in terms of the number of persons who enter the labor market, but also in terms of the quantity and quality of skills available to employers. As we will see many times throughout the book, persons who maximize utility tend to supply more time and more effort to those activities that have a higher payoff. The **labor supply curve**, therefore, is often upward-sloping, as illustrated in Figure 1-1.

FIGURE 1-1 Supply and Demand in the Labor Market

The labor supply curve gives the number of persons who are willing to supply their services to engineering firms at a given wage. The labor demand curve gives the number of engineers that the firms will hire at that wage. Labor market equilibrium occurs where supply equals demand. In equilibrium, 20,000 engineers are hired at a wage of \$40,000.

