

3rd Edition

Modern Labor Economics

Ronald G. Ehrenberg
Robert S. Smith

Theory and Public Policy



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For Our Families, With Love

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Preface

OVERVIEW OF THE TEXT

Modern Labor Economics: Theory and Public Policy has grown out of our experiences over the last fifteen to twenty years in teaching labor market economics and in conducting research aimed at influencing public policy. Our text develops the modern theory of labor market behavior, summarizes empirical evidence that supports or contradicts each hypothesis, and illustrates in detail the usefulness of the theory for public policy analysis. We believe that showing students the social implications of concepts enhances the motivation to learn them and that using the concepts of each chapter in an analytic setting allows students to see the concepts in action. The extensive use of detailed policy applications constitutes a major innovation in this text.

Modern Labor Economics is designed for one-semester or one-quarter courses in labor economics at the undergraduate or graduate level for students who may not have extensive backgrounds in economics. Since 1974 we have taught such courses at the New York State School of Industrial and Labor Relations at Cornell University. The undergraduate course requires only principles of economics as a prerequisite, and the graduate course (for students in a professional program akin to an MBA program) has no prerequisites. We have found that it is not necessary to be highly technical in one's presentation in order to convey important concepts and that students with limited backgrounds in economics *can* comprehend a great deal of material in a single course. However, for students who have had intermediate microeconomics, we have included fourteen chapter appendices that discuss more advanced material or develop technical concepts in much greater detail than the text discussion permits.

Chapter 2 presents a quick overview of demand and supply in labor markets so that students will see from the outset the interrelationship of the major forces at work shaping labor market behavior. This chapter can be skipped or skimmed by students with strong backgrounds in economics or by students in one-quarter courses. Chapters 3 to 5 are concerned primarily with the demand for labor, while Chapters 6 to 10 focus on labor supply issues. Compensation, unionism, public sector labor markets, and discrimination are treated in Chapters 11–14. The final two chapters treat the issues of unemployment and inflation.

In addition to the use of public policy examples and the inclusion of technical appendices, the text has a number of unique pedagogical features. First, each chapter contains boxed examples that illustrate an application of that chapter's theory in nontraditional, historical, business, or cross-cultural settings. Second, each chapter contains a number of discussion or review questions that allow students to apply what they have learned to specific policy questions. Third, lists of selected readings at the ends of chapters refer students to more advanced sources of study.

COMMENTS ON THE THIRD EDITION

Our goal in writing *Modern Labor Economics: Theory and Public Policy* was to provide a comprehensive survey of the field of labor economics written in a style that is interesting and accessible to students of varying backgrounds. We believe this third edition offers two major categories of improvements and innovations that should enhance its value to students and professors.

First, several new applications or theoretical/empirical developments have been included in the textual discussions, in three new appendices, and in nineteen new boxed examples. Among the most significant additions are the following:

Chapter 8: a discussion of status-seeking behavior and an introduction to the game-theoretic problem of the “Prisoner’s Dilemma.”

Chapter 9: an appendix on measuring earnings inequality.

Chapter 10: a text section and an appendix on immigrant cohort quality changes.

Chapter 11: new discussions of efficiency wages, pay in large firms, the earnings/experience relationship, and incentive pay; an appendix devoted to analyzing the demand for labor under revenue- or profit-sharing pay plans.

Chapter 12: a section on alternative models of strike activity.

Chapter 14: expanded treatments of male/female earnings differences and of dual labor markets.

Chapter 15: new or revised sections on efficiency wages and wait unemployment, the full-employment rate of unemployment, and temporary shocks and the persistence of unemployment.

Chapter 16: new analyses of rational and adaptive expectations, wage

norms, and share wages; revised discussions of demographic changes and the Phillips curve, and of long-run trade-off curves (appendix).

Second, we have sought to improve student understanding of economic concepts in three ways. We have expanded the number of review questions at the end of each chapter and have provided answers (at the end of the book) to the odd-numbered questions. We identify and highlight, in each chapter, one of six frequently misunderstood fundamentals of labor economics. Incomplete mastery of these basic principles is at the root of many student misconceptions, and we believe that analysis of these misunderstandings can contribute to the learning process. Finally, a *Study Guide* to accompany this third edition is being published and will be available for student purchase. It contains sequenced questions for each chapter that we believe can materially improve the learning process.

ACKNOWLEDGMENTS

Several colleagues have contributed, through their thoughtful evaluations of the second edition, to the development of the third. While we have not always taken their advice, we appreciate the suggestions and criticisms of the following people:

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Special thanks go to Professor Robert J. Flanagan at Stanford, who wrote portions of Chapter 14 in connection with our other textbook, *Labor Economics and Labor Relations*. He also reviewed several chapters and made many helpful suggestions in the course of writing that text, and his work on that text has strengthened this one.

The above list is only a partial indicator of the extensive developmental editing of *Modern Labor Economics* and the concern of our editor, George Lobell, that we produce a book that accurately reflects the current state of labor economics and is comprehensible to students of varying backgrounds. Indeed, to ensure the book's accessibility, we circulated widely drafts of *Modern Labor Economics* while writing the first two editions. Only space constraints prevent us from acknowledging again the 41 economists who provided invaluable help with our earlier editions.

Enormous debts are also owed to three other groups of people. First are those instrumental in teaching us the concepts and social relevance of labor economics when we were students: Frank Brechling, George Delehanty,

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CHAPTER ONE

Introduction

Economic theory provides powerful, and often surprising, insights into individual and social behavior. At a purely scientific level, these insights are interesting because they help us understand important aspects of our lives. Beyond this, however, government, industry, labor, and other groups have increasingly come to understand the usefulness of the concepts and thought processes of economists in formulating social policy. This theory of behavior is simple yet compelling, and provides a systematic approach to the analysis of economic problems.

This book presents a comprehensive and understandable application of economic analysis to the behavior of, and relationship between, employers and employees. The aggregate compensation received by employees from their employers was \$2,373 billion in 1985, while all *other* forms of personal income that year—from investments, self-employment, pensions, and various government welfare programs—amounted to \$843 billion. The *employment* relationship, then, is one of the most fundamental relationships in our lives, and as such it attracts a good deal of legislative attention. A mastery of the fundamentals of labor economics is thus essential to an understanding of a huge array of social problems and programs.

As economists who have been actively involved in the analysis and evaluation of labor-related policies adopted or considered by the government, we obviously believe labor economics is useful in understanding the effects of these policies. Perhaps more important, we also believe policy analysis can be useful in teaching the fundamentals of labor economics. We have therefore incorporated such analyses into each chapter with two pedagogical purposes in mind. First, we believe that seeing the relevance and social implications of concepts studied enhances the student's motivation

to learn. Second, using the concepts of each chapter in an analytical setting serves to reinforce understanding by permitting the student to see them “in action.”

THE LABOR MARKET

There is a rumor that one recent Secretary of Labor attempted to abolish the term “labor market” from departmental publications. He believed it demeaned workers to regard labor as being bought and sold like so much grain, oil, or bonds. True, labor is somewhat unique. Labor services can only be rented; workers themselves cannot be bought and sold. Further, because labor services cannot be separated from workers, the conditions under which such services are rented are often as important as the price. Put differently, *nonpecuniary factors*—such as work environment, risk of injury, personalities of managers, and flexibility of work hours—loom larger in employment transactions than they do in markets for commodities. Finally, a host of institutions and pieces of legislation that influence the employment relationship do not exist in other markets.

Nevertheless, the circumstances under which employers and employees rent labor services clearly constitute a market for several reasons. First, institutions have been developed to facilitate contact between buyers and sellers of labor services. This contact may come about through want ads, union hiring halls, employment agencies, placement offices, or plant personnel offices.

Second, once contact is arranged, information about price and quality is exchanged. Employment applications, interviews, and even word-of-mouth information from friends illustrate this kind of exchange in the market for labor.

Third, when agreement is reached, some kind of *contract* is executed covering compensation, conditions of work, job security, and even duration of the job. At times the contract is formal, such as with collective bargaining (union–management) agreements. At other times the agreement is unwritten and informal, with only an implied understanding between the parties based on past practices and experience. Nonetheless, it is often useful to think of the employment relationship as governed by a contract.

Labor contracts typically call for employers to compensate employees for their *time* and not for what they produce. Only 14 percent of U.S. workers receive piece-rate wages or commissions, in which compensation is computed directly on the basis of output. The vast majority are paid by the hour, week, or month. They are paid, in short, to show up for work and (within limits) to follow orders. This form of compensation requires that employers give careful attention to worker motivation and dependability in the selection and employment process.

The end result of employer–employee transactions in the labor market is, of course, the placement of people in jobs at certain rates of pay. This allocation of labor serves not only the personal needs of individuals but the