LABOR ECONOMICS: SOME BASIC CONCEPTS

Labor economics is the study of the workings and outcomes of the market for labor. More specifically, labor economics is primarily concerned with the behavior of employers and employees in response to the general incentives of wages, prices, profits, and non pecuniary aspects of the employment relationship, such as working conditions. These incentives serve both to motivate and to limit individual choice. The focus in economics is on inducements for behavior that are impersonal and apply to wide groups of people.

In this book we shall examine, for example, the relationship between wages and employment opportunities, the interaction between wages, income, and the decision to work, the way general market incentives affect occupational choice, the relationship between wages and undesirable job characteristics, the incentives for and effects of educational and training investments, and the effects of unions on wages, productivity, and turnover. In the process, we shall analyze the employment and wage effects of such social policies as the minimum wage, overtime legislation, pension reform regulations, the Occupational Safety and Health Act, welfare reform, payroll taxes, unemployment insurance, immigration policies, the rise in the mandatory retirement age, and antidiscrimination laws. Our study of labor economics will be conducted on two levels. Most of the time we shall use economic theory to analyze "what is", that is, we shall explain people's behavior using a mode of analysis called positive economics. Less commonly, we shall use normative economic analysis to judge "what should be."Positive Economics Positive economics is a theory of behavior in which people are typically assumed to respond favorably to benefits and negatively to costs. In this regard, positive economics closely resembles Skinnerian psychology, which views behavior as shaped by rewards and punishments. The rewards in economic theory are pecuniary and pecuniary gains (benefits), while the punishments are forgone opportunities (costs). For example, a person motivated to become a surgeon because of the earnings and status surgeons command must give up the opportunity to become a lawyer and must be available for emergency work around the clock. Both the benefits and costs must be considered in making this career choice. Likewise, a firm deciding whether to hire an additional worker must weigh the wage and salary costs against the added revenues or cost savings made possible by expanding its work force.Scarcity The most all pervasive assumption underlying economic theory is that of resource scarcity. According to this assumption, individuals and society alike do not have the resources to meet all their wants. Hence, any resource devoted to satisfying one set of desires could have been used to satisfy another set, which means that there is a cost to any decision or action. The real cost of using labor hired by a government contractor to build a road, for example, is the production lost by not devoting this labor to the building of an airport or some other good. Thus, in popular terms, "There is no such thing as a free lunch," and we must always make choices and live with the rewards and costs these choices bring us. Moreover, we are always constrained in our choices by the resources available to us.Rationality The second basic assumption of positive economics is that people are rational in the sense that they have an objective and pursue it in a reasonably consistent fashion. When considering persons, economists assume that the objective being pursued is utility maximization, that is, people are assumed to strive toward the goal of making themselves as happy as they can (given their limited resources). Utility, of course, encompasses both pecuniary and non pecuniary dimensions. When considering the behavior of firms, which are inherently nonpersonal entities, economists assume the goal of behavior to be that of profit maximization. Profit maximization is really just a special case of utility maximization in which pecuniary gain is emphasized and non pecuniary factors are ignored. The assumption of rationality implies a consistency of response to general economic incentives and an adaptability of behavior when those incentives change. These two characteristics of behavior underlie predictions about how workers and firms will respond to various incentives. Rationality cannot be directly proven, however, and even totally habit bound or unthinkingly impulsive people might be forced to alter their behavior in predictable ways if the resources at their command changed. Thus, while we shall maintain the assumption of rationality throughout this text, this assumption is not absolutely necessary to the derivation of at least some of the behavioral predictions contained herein.The Models and Predictions of Positive Economics Behavioral predictions in economics flow more or less directly from the two fundamental assumptions of rationality and scarcity. Workers must continually make choices, such as whether to look for other jobs, accept overtime, seek promotions, move to another area, or acquire more education. Employers must also make choices concerning, for example, the level of output and the mix of machines and labor to use in production. Economists usually assume that, when making these choices, employees and employers are guided by their desires to maximize utility or profit, respectively. However, what is more important to the economic theory of behavior is not the particular goal of either employees or employers, rather, it is that economic actors weigh the costs and benefits of various alternative transactions in the context of achieving some goal or other. For example, when analyzing race or sex discrimination (see Chapter 14), economists frequently assume that employers are maximizing utility, not profits. Likewise, workers utility is normally assumed to be a function of their own consumption, but the concept of utility maximization call be expanded to include both one's own consumption and one' relative to the consumption of others (see Chapter 8 for a discussion of status-seeking behavior in labor markets). Again, fundamental to positive economics are the assumptions that employers and employees act in purposeful and considered ways.**It is important to note several things about them above predictions:**1. The predictions emerge directly from the twin assumptions of rationality and scarcity. Employees and employers, both mindful of their scarce resources, are assumed to be on the lookout for chances to improve their well being. The predictions are also based on the assumptions that employees are aware of, or can learn about, alternative jobs and that these alternatives are open to them. If any of these assumptions is invalid or inappropriate, the predictions would not be consistently borne out by observed behavior.2. The prediction of a negative relationship between wages and voluntary turnover is made holding other things equal. The theory does not deny that job characteristics other than wages matter to employees or that employers can lower turnover by policies other than the wage rate. However, holding these other factors constant, we should observe the predicted negative relationship if the basic assumptions are valid.3. The assumptions of them theory concern individual behavior of employers and employees, but the predictions are about an aggregate relationship between wages and turnover. The prediction is not that all employees will remain in their jobs if they experience all increase in wages, but that enough will remain for turnover to be cut by raising wages. The test of the prediction thus lies in finding out if the predicted relationship between wages and turnover exists as one looks at aggregate data from firms or industries.In fact, there is abundant evidence that these predictions about turnover are accurate. Two of the more convincing studies estimate that if an industry increased its wage rate by 10 percent relative to other industries, holding all other job characteristics constant, it would reduce its voluntary turnover by 3 to 20 percent.Normative Economics Any normative statement a statement about what ought to exist is based on some underlying value. The value premise upon which normative economics rests is that of mutual benefit: A mutually beneficial transaction is one in which there are no losers and, therefore, one that everyone in society could support. A transaction can be unanimously supported whena. All parties affected by the transaction gain,b. Some gain and no one else loses, orc. Some gain and some lose from the transaction, but the gainers fully compensate the losers.When the compensation in c takes place, case c is converted to case b. In practice, economists often judge a transaction by whether the gains of the beneficiaries exceed the costs borne by the losers, thus making it possible that there would be no losers. If the losers sustain losses that the gainers could not possibly compensate, then the transaction could never be mutually beneficial to all and the wisdom of the transaction must be questioned.Ignorance First, people may be ignorant of some important facts and thus led to make decisions that are not in their self interest. For example, a worker who smokes may take a job in an asbestos processing plant not knowing that the combination of smoking and inhaling asbestos dust substantially raises the risk of disease. Had the worker known this, he or she would probably have stopped smoking or changed jobs, but both transactions were "blocked" by ignorance.Transactions Barriers Second, there may be some barrier to the completion of a transaction that could be mutually beneficial. Often such a barrier is created by law. For example, a firm may be willing to offer overtime to production workers at rates no more than 10 percent above their normal wage. Some workers might be willing to accept overtime at the 10 percent premium. However, this transaction, which is desired by both parties, could not legally be completed in most instances because of a law (the Fair Labor Standards Act) requiring almost all production workers to be paid a 50 percent wage premium for overtime. In this case, overtime would not be worked and both parties would suffer.Non Existence of Market A third reason why transactions that are mutually beneficial may not occur is that it may be impossible or uncustomary for buyers and sellers of certain resources to transact. As an illustration, assume that a woman who does not smoke works temporarily next to a man who does. She would be willing to pay as much as 50 cents an hour to keep her working environment smoke free, and he could be induced to give up smoking for as little as 25 cents an hour. Thus, the potential exists for her to give him 35 cents an hour and for both to benefit. However, custom or the transience of their relationship might prevent her from offering him money in this situation, in which case the transaction would not occur.