LECON 2608 Advanced Labor Economics Introduction

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Pure competition on the labor market?



Is labor a good like any other?



Outline of LECON 2608



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Evidence against pure competition on the labor market?

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Pure competition on the labor market requires strong assumptions:

- Workers and employers are literally atoms taking wages as given.
- 2 There is perfect information on the labor market.
- Perfect mobility of workers between employers, sectors, regions.

Implication of these assumptions:

"The law of one price":

The competitive wage (for *homogeneous* labor) should be unique.

"In a perfectly competitive market, a firm need not make decisions on its pay schedules; instead it would turn to the morning newspaper to learn what its wage policy would have to be. Any firm, by raising wages ever so little, could get extra help it wanted. If, on the other hand, it cut the wage ever so little, it would find no labor to hire at all in a perfect competitive labor market." (Samuelson, 1958, p. 559)

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Imperfections

- Wage-setters
 - "Large" employers are not uncommon: They have no reason to be wage-takers.
 - In some countries, (part of the) workforce is unionized. Unions do many things; in particular, they bargain over wages.
- Imperfect information is widespread. Even small deviations from perfect information have dramatic implications (Stiglitz, 2002).
- Perfect mobility is an extreme assumption.

"The competitive market for a commodity, where all units are interchangeable and all trade for the same price, could hardly be a worse description of the labor market. No Walrasian auctioneer determines the wage." (Hall and Krueger, 2012)

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To what extent do these imperfections matter?

Let us focus on the "law of one price" restated when workers or jobs are heterogeneous:

Claim: In a perfectly competitive labor market, wage differences across workers reflect only differences in

- The worker's ability / productivity
- Non-monetary attributes of the jobs: Exposure to pollution, special work-time scheduling and the like.

The theory of Equalizing Differences² (Rosen, 1986) develops this property under the assumption that rational workers care about earnings (consumption) and these non-monetary attributes (bullet 2). In a nutshell, according to this theory there must exist positive (resp., negative) wage differentials for disamenities (resp., amenities).

²= the theory of "compensating wage differentials" = "hedonic theory of wages".

Is the previous claim empirically verified?

Answering this question turns out to be complicate.

 \rightarrow There are measurement issues:

What is the quality of data about ability, productivity, job (dis)amenities?

 \rightarrow There are also econometric issues:

In particular, once proxies have been found for these determinants, are they exogenous?

Many attempts exist to test the above claim. Let's have a quick look at this literature...

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1. Mincer log wage equations

Education (Schooling) and training during the working life (captured below through "experience") as proxies for workers' productivity (inspired by "human capital theory" under perfect competition; see Willis, 1986, or a labor economics textbook):

 $\log(w_{it}) = \alpha_{(i)} + \beta_1 \cdot \text{Schooling}_{i(t)} + \beta_2 \cdot \text{EXP}_{it} + \beta_3 \cdot \text{EXP}_{it}^2 + \varepsilon_{it}$

where

- *w_{it}*: the hourly wage of salaried worker *i* at time *t*;
- 'Schooling': Measured by the number of years or a set of dummy variables (educational levels: primary,...); often not time-dependent;
- 'EXP': (actual or potential) experience on the labor market;
- *ε_{it}*: unobserved heterogeneity (E[ε_{it}] = 0). Could in particular include the non-monetary attributes of the job.

With cross-sectional data $\alpha_i = \alpha$.

"Observable worker characteristics that are supposed to account for productivity differences typically explain no more than 30 percent of the variation in compensation across workers in these studies" [i.e. estimating Mincer equations] (Mortensen, 2003, p.1)

To improve the fit, econometricians have often added to the above specification a number of explanatory variables such as:

- Gender dummies,
- Ethnic dummies,
- Location (e.g. large cities vs other locations),
- Working time, type of contracts, ...

Justifications?

An example among many others

Cross-sectional survey data in 2003; Source: Bazen (2011)

$$\log(w_i) = \underbrace{1,56}_{(0,078)} + \underbrace{0,095}_{(0,003)} \cdot \underbrace{\text{Schooling}_i + 0,038}_{(0,008)} \cdot \underbrace{\text{EXP}_i}_{(0,008)} \\ -\underbrace{0,0006}_{(0,002)} \cdot \underbrace{(\text{EXP}_i)^2 - 0,13}_{(0,007)} \cdot \underbrace{\text{Female}_i + 0,093}_{(0,01)} \cdot \underbrace{\text{Paris}_i}_{(0,01)}$$

 $R^2 = 0,326$. Standard error between parenthesis; 7251 obs.

Where

 \Diamond 'Schooling' $\in \{0,1,...6\}$ measures the number of successful years of schooling beyond compulsory education.

 \diamond 'EXP' = the number of years of potential experience, i.e. the number of years between the current age and the end of full-time education.

 \diamond 'Female' is a dummy variable (1 if female, 0 if male).

◊ 'Paris' is a dummy variable (1 if living in the Paris region, 0 otherwise).

ESL (UCLouvain)

2. Generalizations to improve the explanatory power Cahuc, Carcillo and Zylberberg (2014), p. 300

Under pure competition, perfect mobility precludes that an industry or firm pays his workers better than others (conditional on abilities and non-monetary job attributes).

$$\begin{aligned} \log(w_{it}) &= & \alpha_i + \beta_1 \cdot \text{Schooling}_{it} + \beta_2 \cdot \text{EXP}_{it} + \beta_3 \cdot \text{EXP}_{it}^2 \\ &+ & \sum_{j=1}^J \gamma_j \cdot d_{ijt} + \varepsilon_{it}, \end{aligned}$$

Where

- $d_{ijt} = 1$ if worker *i* is of type *j* at time *t* in which "type j" can be
 - (2.1) sector (or industry) *j* or,
 - (2.2) firm *j* ; (0 otherwise)

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2.1 Inter-industry wage differentials: J sectors

Persistent inter-industry wage differentials are widespread. They question the perfect competition assumption. However, is the evidence causal?

As shown by the table on the next slide,

- With cross-sectional data (⇒ α_i = α): Strong evidence that the sectoral dummies have a significant effect under the questionable assumption that d_{ijt} ⊥ ε_{it} (Goux and Maurin, 1999)
- With panel data (with fixed effect α_i) : Weak or insignificant effects of sectoral dummies (Goux and Maurin, 1999).
- So, (persistent) inter-industry wage differentials reflect mainly unobserved individual (fixed) effects rather than a sign of <u>imperfectly competitive markets</u>. → Sorting is at work.

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Industry	Model without fixed individual effect	Model with fixed individual effect
Agriculture	-0.101 (0.07)	-0.017 (0.016)
Mining (coal)	0.139 (0.020)	0.058 (0.056)
Petroleum	0.210 (0.018)	0.049 (0.027)
Electricity	0.108 (0.007)	0.058 (0.019)
Chemical	0.163 (0.009)	0.016 (0.019)
Food retail	-0.112 (0.007)	-0.043 (0.014)
Hotels, bars and restaurants	-0.175 (0.006)	-0.008 (0.012)

Figure: Estimates of inter-industry differences in France, 1990-1995. Hourly wages. Field: Men, wage earners. Selected industries. The figures in parentheses are standard errors. Source: Goux and Maurin (1999)

Aside from industry, the variables introduced in the models are job experience, job tenure, nationality, place of residence, education, and occupation.

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2.2 Inter-firm wage differentials: J firms

- Firms fixed effects γ_i identified thanks to
 - Large matched employer-employee data on wage-earners-employers pairs observed through time.
 - Hence, identification of firm fixed effects thanks to workers who change firms. Key assumption: this mobility is ⊥ ε_{it}.
 - Several econometric issues are discussed by Card, Cardoso, Heining and Kline (2018) but not below.
- Message: Individuals with identical individual observed characteristics are paid differently in different firms. See next slide.

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	France (1976-1999)	United States (1990-1999)
EXP and EXP ²	17	5
Person effect	29	24
Firm effect	23	24
Residual	31	47

Table: Components in % of variations of (log of) real annual wages in France and in the US.

Source: Extracted from Cahuc, Carcillo and Zylberberg (2014), p. 302; based on research made by Abowd, Kramarz, Lengermann and Roux (see e.g. Abowd and Kramarz, 1999).

<u>Note:</u> Other evidence about the importance of firm-pay policies can be found e.g. in Barth, Bryson, Davis and Freeman (2016) and in Card, Cardoso, Heining and Kline (2018).

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3. Summing up

- There is evidence of persistent wage dispersion that cannot be reconciled with perfect competition on the labor market...
- ... unless unobserved non-monetary attributes of jobs are largely firm-specific.
- This requires that the evidence in favor of the theory of equalizing (or compensating) differences is strong.
 - "Typical estimates in this literature, [...], are of small order of magnitude, often less than 5% of the wage, if not insignificantly different from zero or wrong-signed" (Bonhomme and Jolivet, 2009, p. 763)
 - Cahuc, Carcillo and Zylberberg (2014) are more positive: "Empirical tests [...] give qualified results, which nevertheless, in many cases, highlight compensating wage differentials linked to the nonwage aspects of jobs." (p. 176)

4. Other evidence against pure competition

Recall

"In a perfectly competitive market, [...] Any firm, by raising wages ever so little, could get extra help it wanted. If, on the other hand, it cut the wage ever so little, it would find no labor to hire at all in a perfect competitive labor market." (Samuelson, 1958, p. 559)

So, a different approach consist in addressing the question: How elastic is the supply of labor to a single firm? Under pure competition it should be huge.

A growing number of papers conclude it is not. See e.g. Dube, Jacobs, Naidu and Suri (2020) for a recent evidence for online labor markets.

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The approach privileged by LECON2608

= To focus on alternatives to pure competition, considering this theoretical framework as a possible limit case.

These alternatives will in particular emphasize

• Imperfect (symmetric) information leading to so-called "search-matching frictions".

These frictions generate "match-specific rents" and eventually

- Either individual wage bargaining or
- Monopsony power if firms set unilaterally the wage.
- This the so-called Diamond-Mortensen-Pissarides (DMP) approach (Nobel prize in economics 2010)
- Imperfect competition (in particular, unionized vs non-unionized firms).

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Labor is definitely a quite specific input/good

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Asymmetric information and risk aversion

- Labor is embodied in the seller. Contrary to other goods, labor is inseparable from the worker. Hence, "buying labor" typically implies a direct, personal relationship between the buyer and the seller;
- 2 Asymmetric information is widespread \Rightarrow No pure competition;
- There are "spot labor markets" but employment relationship has often a "long-term" nature;
- The worker's human capital cannot easily be diversified while risk and uncertainty prevail on the labor market
 - + Those risks are hardly covered by private insurance;

LECON2608 also introduces to 'personnel economics' i.e. Economics applied to Human Resource Management, emphasizing *asymmetric information and risk aversion*.

A job <u>can</u> be more than a wage

- The compensation provides a certain degree of *autonomy* in the conduct of one's life (in comparison with getting the money or the goods from parents, a husband, social security,...);
- Having a job can mean being part of a *social group*, a community (creating social ties, possibly the feeling of being member of the "working class");
- Being hired by an employer recognizes the worker as someone who is worth to be recruited;
- Having a job can provide a feeling of *usefulness*;
- If the job has specific characteristics (e.g. autonomy, creativity), it can be *interesting per se*.

These dimensions are typically valued by the workers and are an additional source of *asymmetric information*.

See e.g. Cassar and Meier (2018) who emphasize the dimensions in green.

Fairness and social norms

- Fairness: People often care about being fair and treated fairly. This seems to be particularly true in the labor market (see Solow, 1990, for an early contribution).
- More generally: Importance of social norms as to how people think that they and others should behave in labor relationships.

Example: Do unemployed people underbid employed workers (i.e. Do the unemployed offer to work at a wage below that of those in work)?

LECON2608 introduces to Personnel economics when some of the above features (this slide and the previous one) are taken into account.

Clarifying some methodological options.

1. What is "Mainstream" (labor) economics

What is "Mainstream" economics?

"...the existence of mainstream economics ought to be understood as a particular case of the now widespread certification phenomenon, which defines good practices on the grounds of a compliance with well-defined standards" (De Vroey and Pensieroso, 2016)

Arguably, the notion of mainstream (labor) economics can be briefly characterized by:

- Methodological individualism;
- Individuals are in a "position" such that they can make choices & No resources invested in decision making;
- Standard rationality assumptions (satisfying one's preferences);

"Mainstream" (labor) economics

- Everyone is exclusively interested by one's self-interest;
- An "instrumentalist" perspective:
 - People work only in order to be able to consume;
 - 2 An aversion to labor (hours worked, effort on the job \Rightarrow disutility);
- Taking sometimes care of the non-pecuniary (dis)advantages of an occupation (such as the risk of injury considered by the *theory* of compensating wage differentials).

2. Options taken by LECON2608

- Main part: Mainstream labor economics;
- Taking care of "features" that seem pervasive on the labor market: Imperfect information, asymmetric information, imperfect competition, decentralized matching between job-seekers and vacancies,...;
- Extending at some points mainstream labor economics: Behavioral economics, the role of social norms;
- Introducing from time to time what can be learned from other social sciences.
- Empirical work disconnected from theory is largely avoided.
- To go deeper into these choices: Compulsory reading on Moodle: Epistemology and labor economics.pdf;
 Homework: Comments and questions sent by email before the next class meeting to

bruno.vanderlinden@uclouvain.be

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Outline and organization

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- Main objective of LECON2608: To discuss why actual labor markets are far more complex than the convenient purely competitive model.
- Four main channels are discussed:
 - Imperfect competition: firms' market power & employees bargaining power (due to unionisation, turnover costs or investment);
 - 2 Risk aversion when insurance markets are incomplete;
 - Imperfect (symmetric and asymmetric) information;
 - Workers who do not behave as self-interested rational agents (including the role of "social norms").

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Structure

Main themes:

- Job-search
- Pirms' monopsony power
- Job reallocation and unemployment (Equilibrium matching models)
- Collective bargaining
- Ontracts, risk-sharing and incentives (Personnel Economics)

Material covered through:

- Lectures: Theories + empirical methodology & applications
- Homework assignments.

Problem sets or readings indicated during the lectures.

Note: Videos of lectures in 2020 available on Moodle.

Organization

General references (available at the library, place Montesquieu):

- Cahuc, Carcillo and Zylberberg (2014) Labor economics, MIT Press.
- Garibaldi, Pietro (2006), Personnel Economics in Imperfect Labour Markets, Oxford University Press.
- Boeri, Tito, and Jan van Ours (2013), The Economics of Imperfect Labor Markets, 2nd edition, Princeton University Press.
 - The lectures often follow textbook (1).
 - On Moodle: slides, exercises, compulsory readings,...
 - Register as soon as possible on

https://moodle.uclouvain.be;

- Office hours by appointment:
 - Bruno Van der Linden: Collège Dupriez, 3 place Montesquieu, L-L-N. Office D-108 (first floor).

Implications of the COVID-19 crisis

- As long as it is allowed, the lectures will be organized on the campus of Louvain-la-Neuve (the room is not the same each week ⇒ See the syllabus).
- If rules later change, we will have to switch to on-line teaching (Teams).

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- LECON2608 is a graduate course in labor economics. An undergraduate course in labor is NOT a prerequisite.
- However, this course does neither develop labor supply (neither in the short- nor in the long-run), nor labor demand nor the competitive theory of the labor market. However, when needed, it recalls the main properties under pure competition.
- Prerequisites:
 - A course in microeconomics
 - A course in algebra and some familiarity with calculus and, especially, with the concept of derivatives.
 - An introduction to econometrics

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Assessment

- Final mark is a weighted average of two marks:
 - 1) Homework assignments 30%
 - 2) Final exam (during the regular examination period) 70%
- Final exam: Written open-book exam in January (+ second chance after mid-August).
- Questions may relate to topics discussed during the lectures, the problem sets and the compulsory readings. Homework assignments are examples of exam questions.
- The exam aims at evaluating whether students are able to construct a coherent and critical argumentation of labor market issues treated in the lectures. It will also gauge whether the students
 - Understand the logic of arguments within formal economic models,
 - Can exploit these models,
 - Can interpret empirical results in relation with theory.

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