Macroeconomics VI: The Labour Market

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introduction

- "When in any country the demand for those who live by wages… is continually increasing; when every year furnishes employment for a greater number than had been employed the year before, the workmen have no occasion to combine to raise their wages. The scarcity of hands occasions competition among masters, who bid against one another, in order to get workmen…" Adam Smith (1776)

job separation and job finding

- The workforce= employed + unemployed
  - $L=E+U$
- When unemployment is stable, the number of job separations must equal the number of jobs found.
  - $sE=fU$
- but since $E=L-U$
  - $s(L-U)=fU$, divide both sides by L to obtain
  - $s(1-U/L)=fU/L$ and solve for U/L to find
  - $U/L= s/(s+f)$
- The steady-state unemployment rate is an increasing function of the job separation rate and a decreasing function of the job finding rate.

the labour supply decision

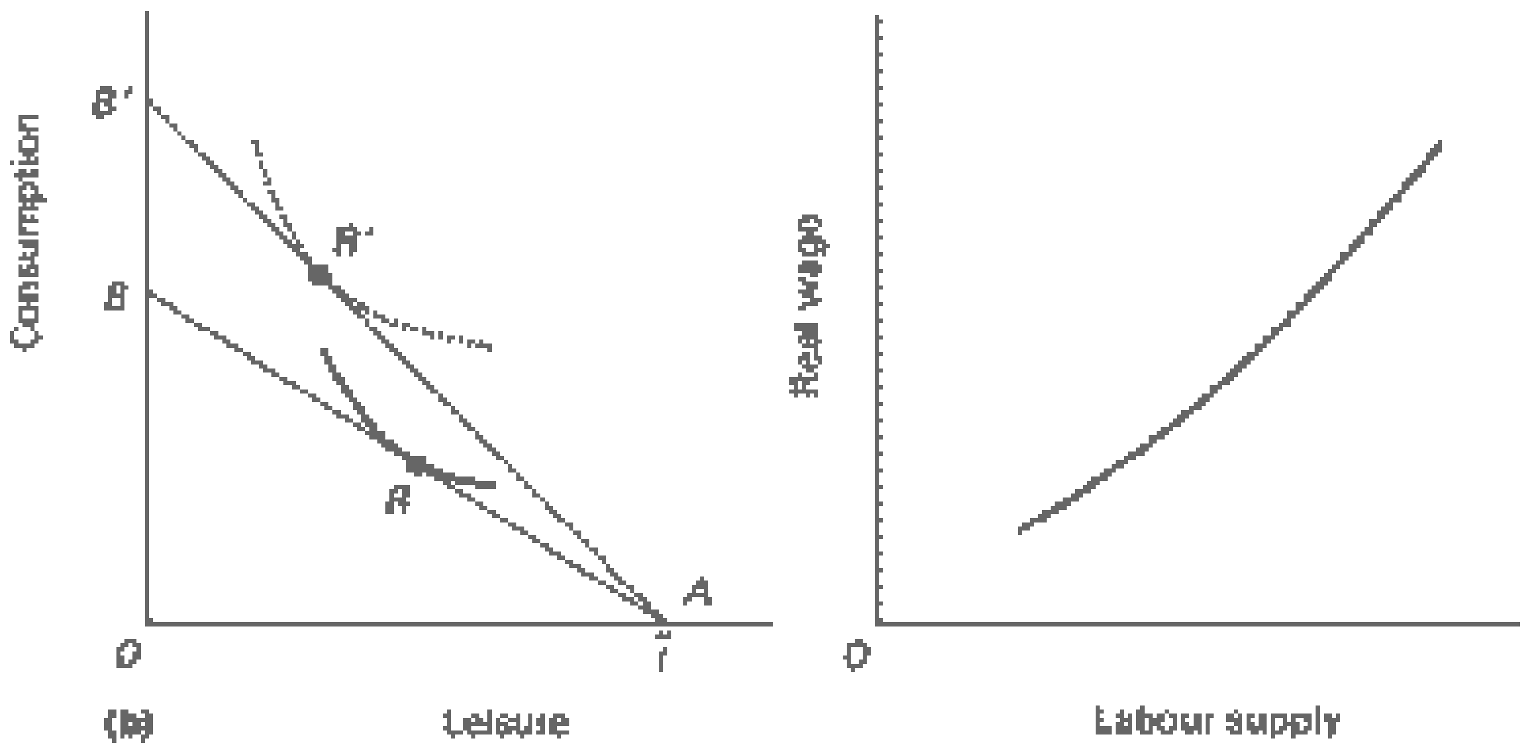
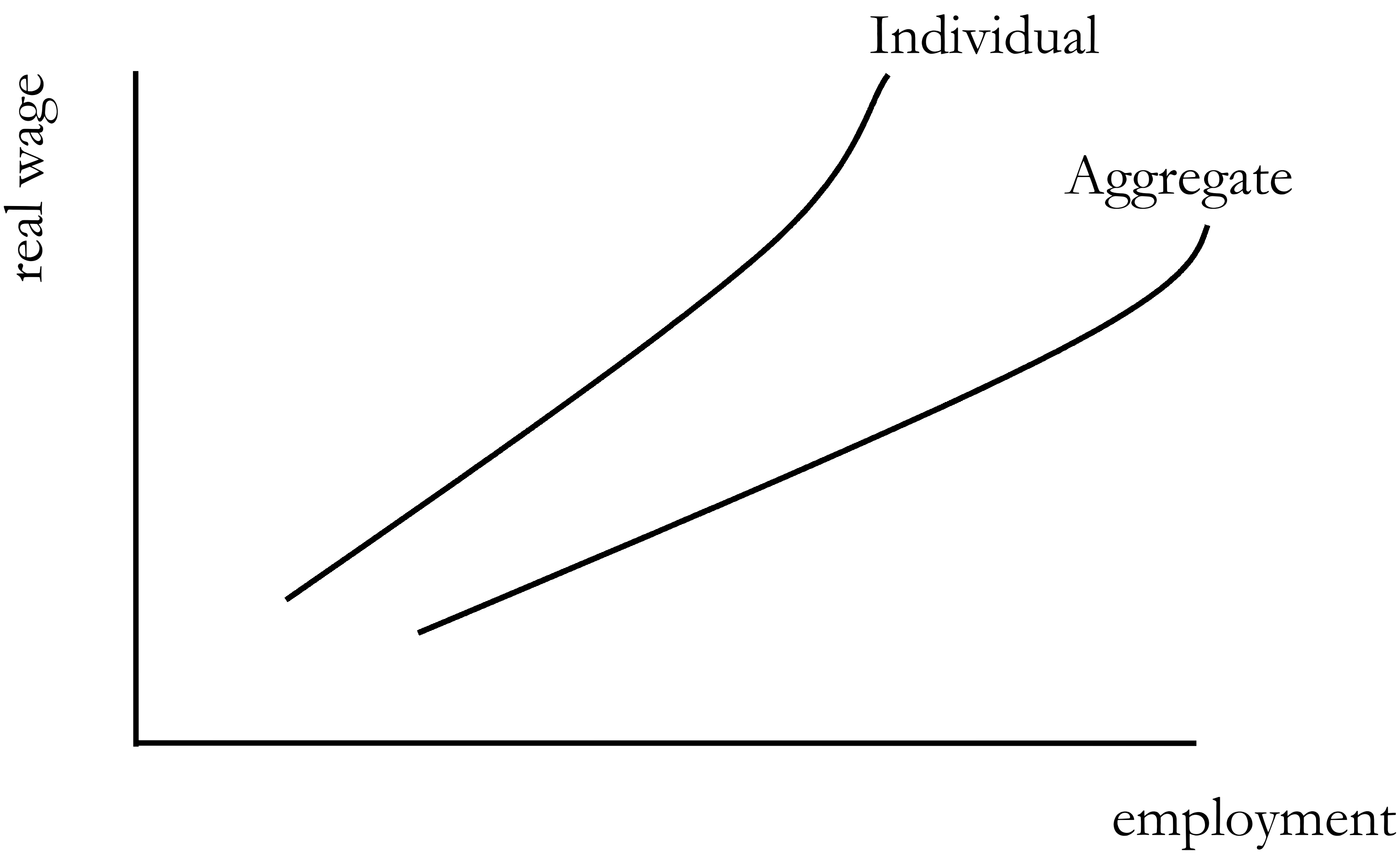
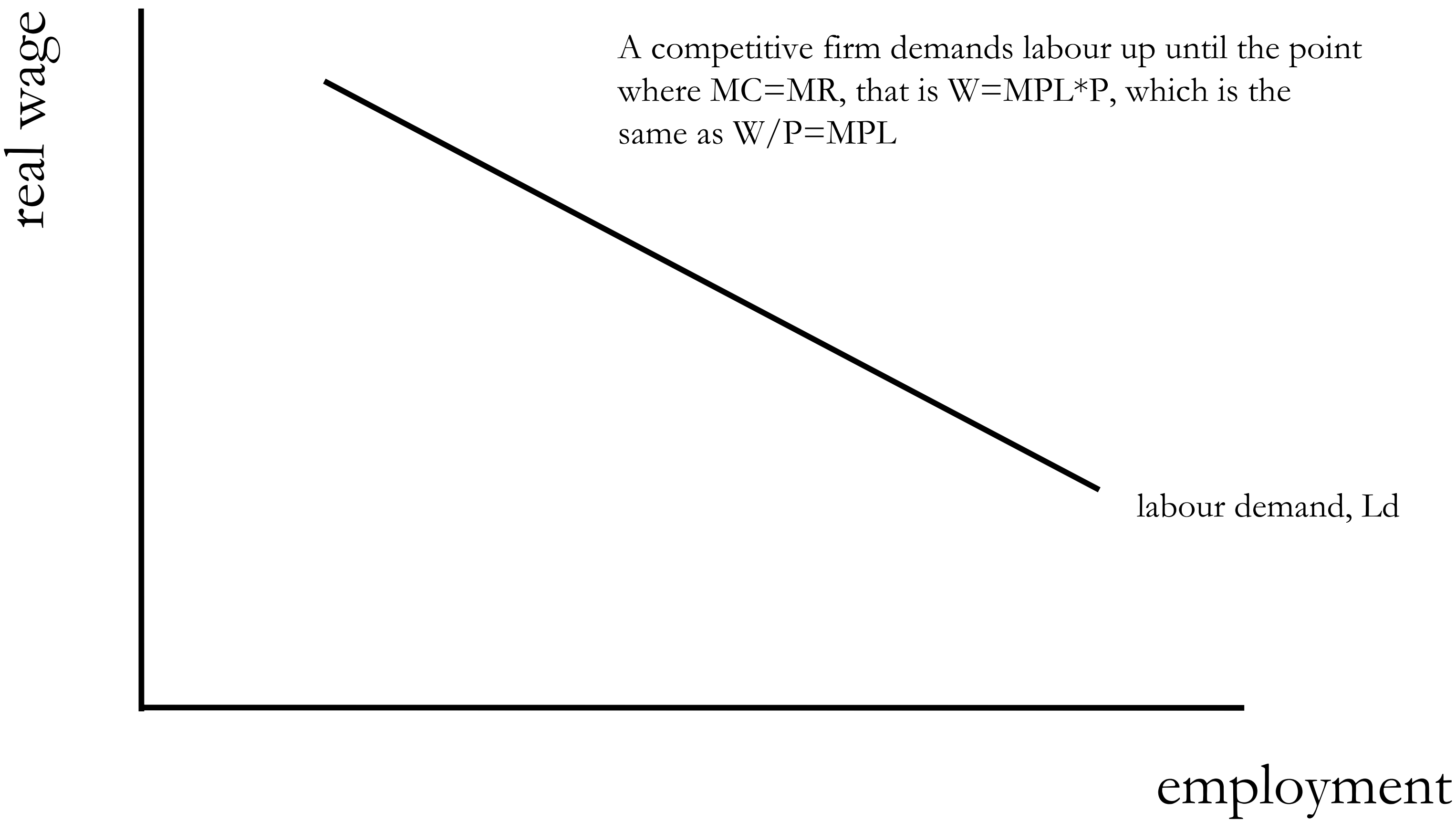


Figure 6.4. (b) Labour Supply

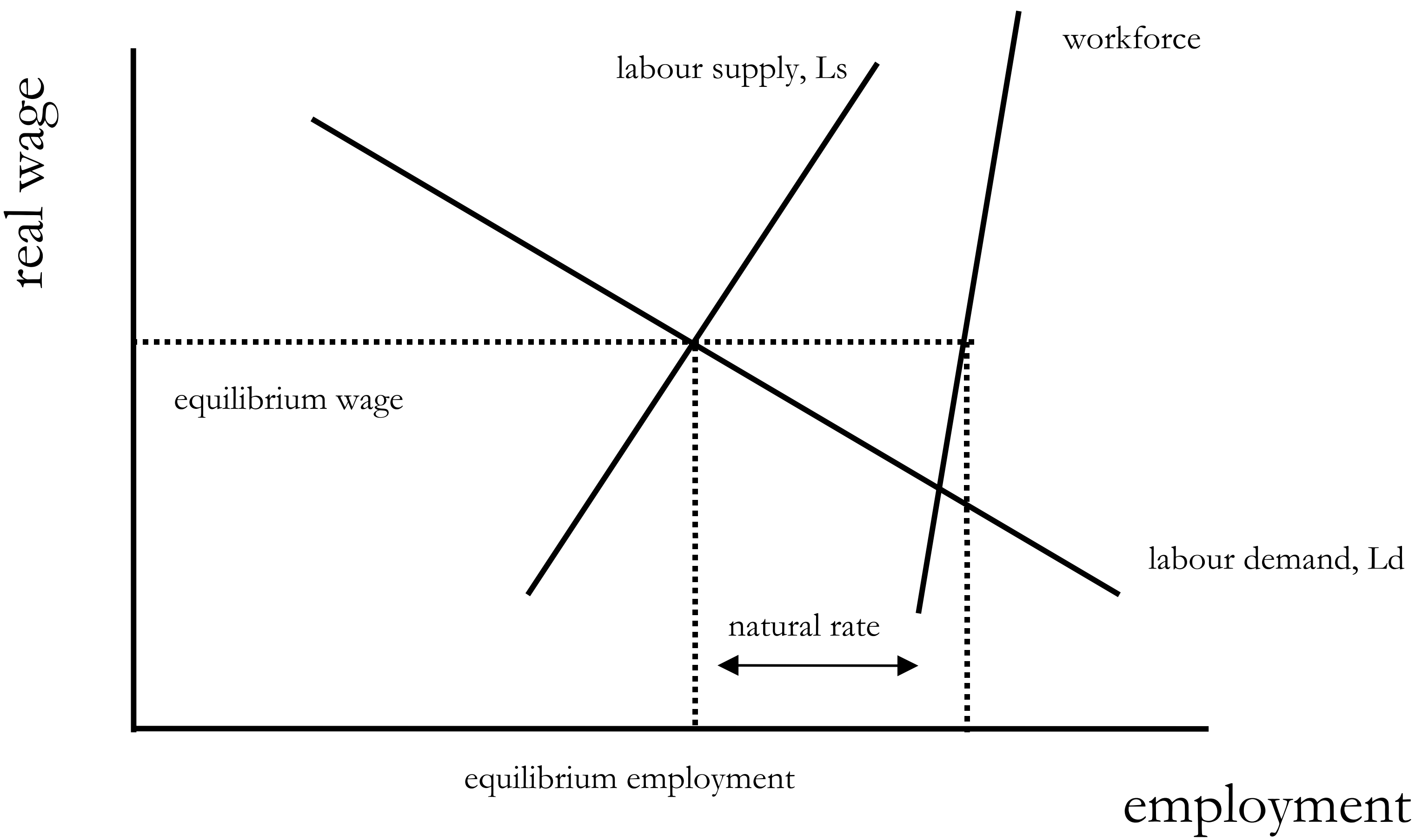
the supply of labour



the demand for labour



the natural rate of unemployment



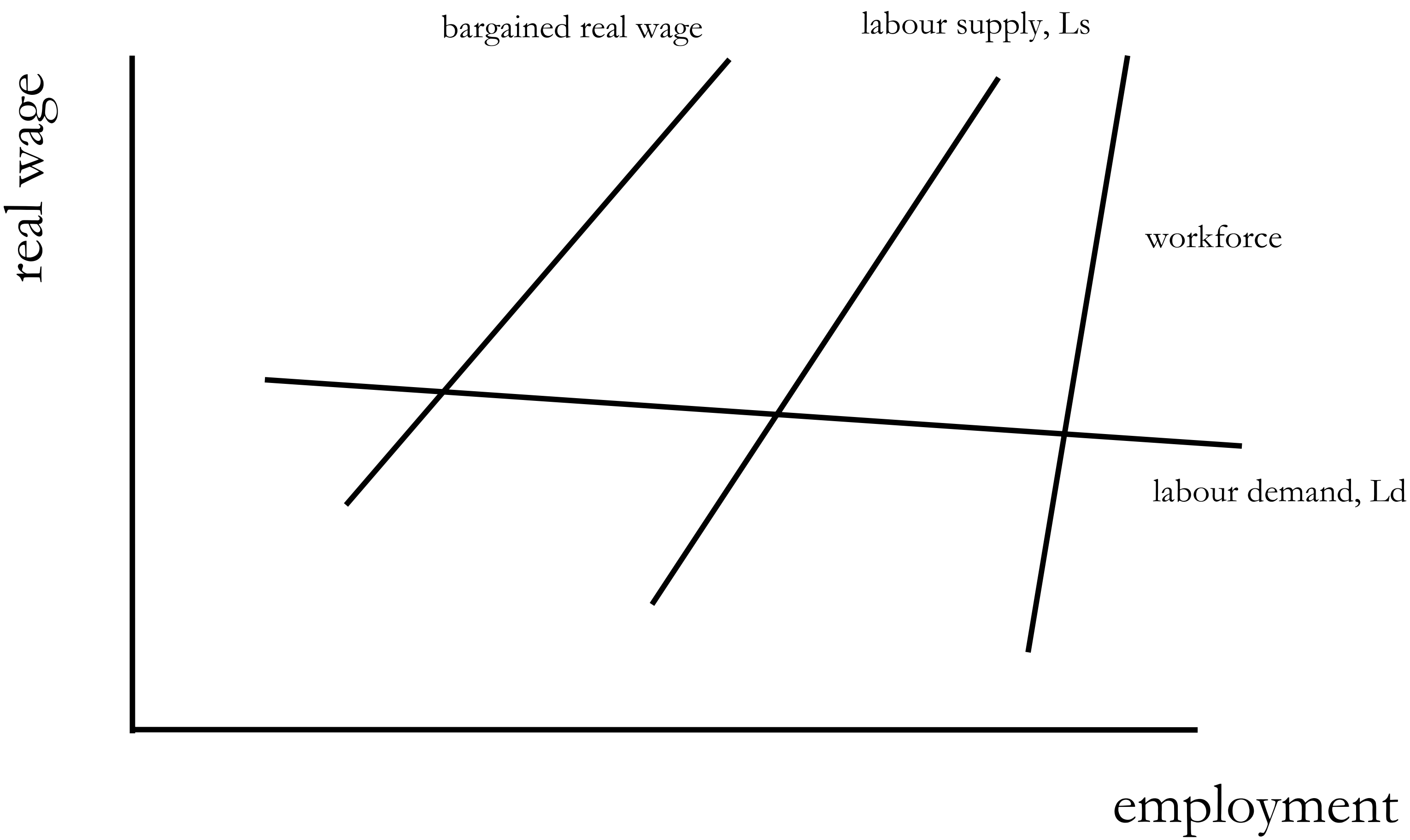
the natural rate and the NAIRU

- The natural rate model assumes that markets clear and that there is competition in all markets.
- In fact, the labour market may be dominated by unions.
- If so, there is bargaining between unions and firms.
- Other things being equal, this will raise the level of unemployment for any given real wage.
- Also, goods markets may be dominated by a few large sellers (imperfect competition) in which case the labour demand curve may be less steep, possibly even horizontal.

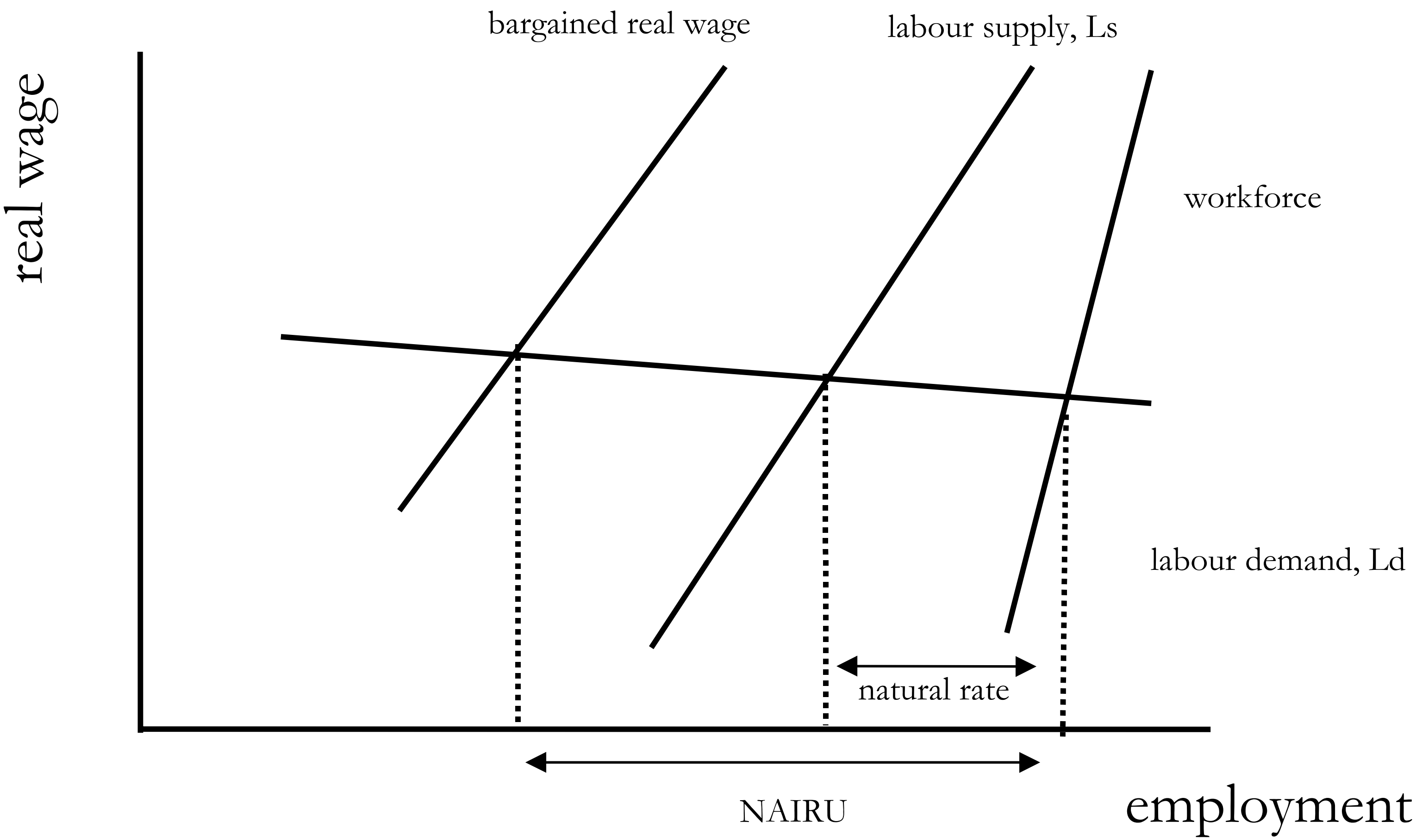
wage bargaining

- Unemployment is the means by which the *competing claims* of employers and unions are reconciled.
- Unions bargain over wages relative to prices (the *bargained real wage)* and reduce their demands when unemployment is high.
- Unions care about the employed (*insiders*) without caring too much about the unemployed (*outsiders*).
- Employers set prices relative to wages: this leads to a relatively flat labour demand schedule.

the bargained real wage



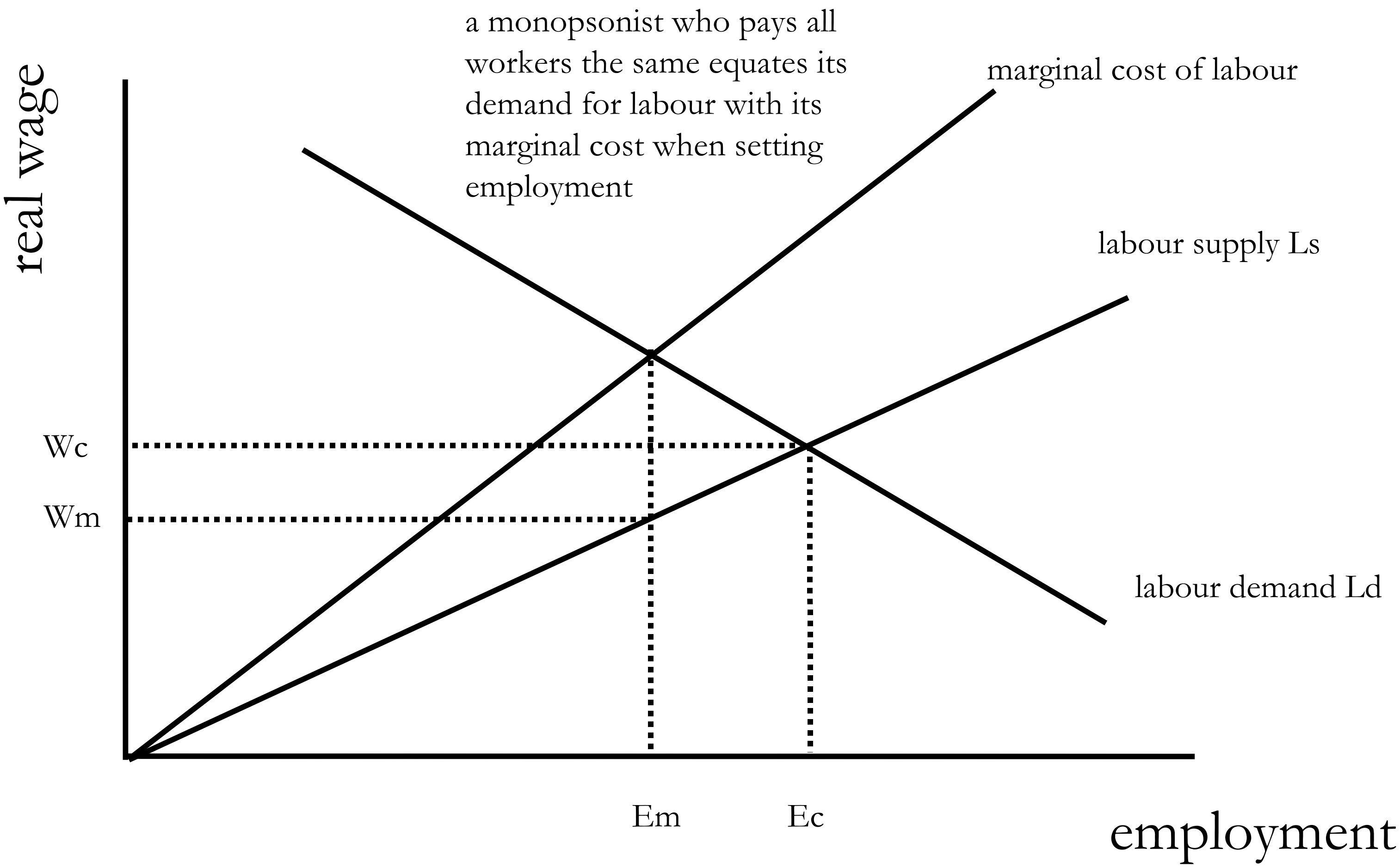
the NRU and the NAIRU



two views of the labour market

- The natural rate model suggests that most equilibrium unemployment is voluntary in the sense that workers could find jobs at the current real wage, but choose not to.
- The NAIRU model suggests that some equilibrium unemployment is involuntary in the sense that workers would like to work at the current real wage but cannot find jobs.

a monopsony labour market



efficiency wages

- In 1914, the Ford Motor Company paid its workers \$5 per day when the going rate was between \$2 and \$3. Why?
- "A low wage business is always insecure… The payment of five dollars a day for an eight hour day was one of the finest cost-cutting moves we ever made", Henry Ford
- Why would this policy *reduce* costs?
- Workers might work harder and staff turnover might be reduced because workers don't want to run the risk of a big cut in wages. The firm may also attract better quality workers.
- If many firms pay efficiency wages, it will be harder for the unemployed to find jobs, and so unemployment will be higher.

the rising UK NAIRU, 1956 to 1987

	1956-59	1960-68	1969-73	1974-80	1981-87
Unemployment %	2.2	2.6	3.4	5.2	11.1
NAIRU %	2.2	2.7	3.8	6.1	6.6
Change in NAIRU		+0.5	+1.1	+2.3	+0.5
-North Sea Oil		+0.0	+0.0	-0.3	-2.6
-Terms of Trade		-0.4	-0.1	+1.5	+1.3
-Skill mismatch		+0.1	+0.3	+0.6	+1.5
-Benefits		+0.3	+0.6	-0.3	+0.5
-Unions		+0.4	+0.3	+0.8	+0.1
-Tax wedge		+0.1	+0	+0	-0.3

how to reduce unemployment

- Retraining and work experience schemes for long-term unemployed and unskilled;
- Reform of the benefit system;
- Limitations on union power & increased employer coordination;
- Tax reform (lower payroll taxes for the unskilled);
- Increased labour mobility & reform of local government finance.

how not to reduce unemployment

- Cunning demand-side policies (unlikely to have much effect in the long-run, plus very expensive);
- Job-sharing or cuts in working hours;
- Increased investment by firms (although this will raise wages);
- Protectionism (any benefit to workers massively outweighed by costs to consumers).

summary

- “When large numbers of people are out of work…. unemployment invariably follows”, Calvin Coolidge (US President, 1923-1929).