

## Labor Market

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According to textbooks such as Ronald Ehrenberg and Robert Smith's "Modern Labor Economics" (2005), a "labor market" is the place where labor services are bought and sold. The term "labor" is equated to the term "work", not only manual work but also knowledge work. Sometimes, the place where labor services are bought and sold is a clearly identifiable one such as a construction site or a lawyer's office. Other times, the place is ill-defined, as for the work of most readers of this article, who are hired in one location and who perform labor services in a number of others, such as offices, libraries, home offices, airplane lounges, and hotel rooms.

Labor markets are defined in overlapping ways - by geography (the New York City labor market), occupation (the labor market for economists), or skill level (the labor market for college graduates).

Whatever the defining criterion may be, labor markets always have two sides: labor demand and labor supply. On the labor demand side are firms (including companies, not-for-profit organizations, and government agencies), which hire labor in order to produce

goods and services. On the labor supply side are workers, who sell their time in exchange for compensation which, in standard terminology, is called the wage.

On both sides of the labor market, the relevant parties engage in purposeful behavior. In the core model of economics, companies seek to maximize the net present value of profit, which is the difference between the revenues they take in from the goods and services they sell and the costs they incur in producing those goods and services. Individuals, for their part, are assumed to seek to maximize utility, which depends positively on the goods they are able to buy with their income and negatively on the amount of leisure foregone while working.

The amount of labor demanded and supplied are both functions of the wage. The amount of labor demanded in a labor market decreases with the wage, all other things being equal. This negative relationship arises for two reasons: a higher wage induces existing employers to hire fewer workers than they would have if the wage had been lower, and it may induce some of these employers to go out of business entirely and hire nobody. On the other hand, the amount of labor supplied to a labor market increases with the wage, all other things being equal. Here too, there are two basic reasons: a higher wage in one labor market induces some workers to enter that labor market from other labor markets and also induces some individuals who are outside the labor market (the old, the young, full-time students) to seek work in this labor market.

Of course, other things are frequently not equal; labor demand and labor supply are functions of these other things as well. For instance, an improvement in product market conditions will cause more labor to be demanded at any given wage than before, and heightened prestige for a given occupation will cause more labor to be supplied at any given wage than before.

As with other markets, a labor market is said to clear when the amount of labor demanded equals the amount of labor supplied. It is said to be in equilibrium when the economy tends toward a particular set of conditions and, once there, tends to stay there.

Whether an equilibrium is characterized by market clearing or not depends on which equilibrating forces are free to operate in the labor market in question. In the standard labor market models, three fundamental equilibrating forces are postulated. First, firms are free to hire as many or as few workers as they want depending on wages and other conditions of employment. Second, workers are free within limits to move from one labor market to another or into and out of the labor force depending on wages and other conditions of employment. And third, the wage paid is free to rise or fall depending on supply and demand conditions.

When all three of these equilibrating forces are free to operate, the labor market is expected to clear in equilibrium. Wages and employment will therefore reflect supply and demand conditions.

The market-clearing model provides enormous insight. It explains, for example, why workers in the United States are paid so much, why workers in Mexico are paid so little, and why professional athletes are paid so much more than farm laborers.

These examples also highlight two important types of restrictions on equilibration in labor markets. First, every country imposes restrictions on international migration. Because of the large differences in labor market earnings, a great many workers in Mexico and other countries would like to become American workers, but U.S. immigration law prohibits them from doing so. An estimated 6 million Mexican workers have taken matters into their own hands and have entered the United States illegally. Second, workers differ in terms of their productivity and skills. It is effectively impossible for farm laborers to acquire the skills needed to become professional athletes.

Beyond these barriers to equilibration, which are ubiquitous, there are also settings in which one of the equilibrating forces, the wage rate, is not free to adjust. Wages may be set above the market-clearing level by a variety of institutional forces including minimum wages, trade unions, multinational corporations, public-sector pay policies, and national labor codes. When this happens, the predictable consequence is unemployment. The high rate of unemployment in Europe compared to North America is usually explained in such terms. Infrequently, the wage in a labor market is set not above the market-clearing level but below it. The government of Singapore did this to try to hold down labor costs and maintain international competitiveness. That nation's wage-restraint policy was halted

only when employers persuaded the government to allow them to raise wages so that they could attract more workers and increase production.

Moving beyond this basic labor market model, a number of other features are at the forefront of labor economics modeling today. Efficiency wage models recognize that a higher wage may increase worker productivity, because existing workers have greater incentives to work more efficiently and/or because firms that pay higher wages attract a larger pool of applicants, from whom they can hire more selectively. Human capital models recognize that workers' skills and productivity can be augmented through education and training. Imperfect information and matching models recognize that it takes time and resources for workers to find appropriate jobs and for firms to find appropriate workers. Models of labor market segmentation and dualism recognize that "good jobs" and "bad jobs" may coexist for workers of a given skill level. Labor market discrimination models recognize that employers, co-workers, and customers may have prejudicial tastes that they exercise in the labor market. In all of these areas, the consequences for employment and wage levels have been carefully worked out.

Finally, a fundamental aspect of labor market economics is that labor markets do not operate in isolation. Wages and employment levels in one geographic area, occupation, or skill group are determined not just by conditions in that labor market but by conditions in other labor markets as well. Multi-sector labor market models, though more complicated than models of individual labor markets, offer insights that models of single labor

markets cannot<em>for example, the understanding that the solution to urban unemployment may be rural development.

### Bibliography

Ehrenberg, Ronald G. and Robert S. Smith, *Modern Labor Economics*, ninth edition.

(Boston: Pearson Addison Wesley).