Labor Demand: Third Lecture

LABOR ECONOMICS (ECON 385)

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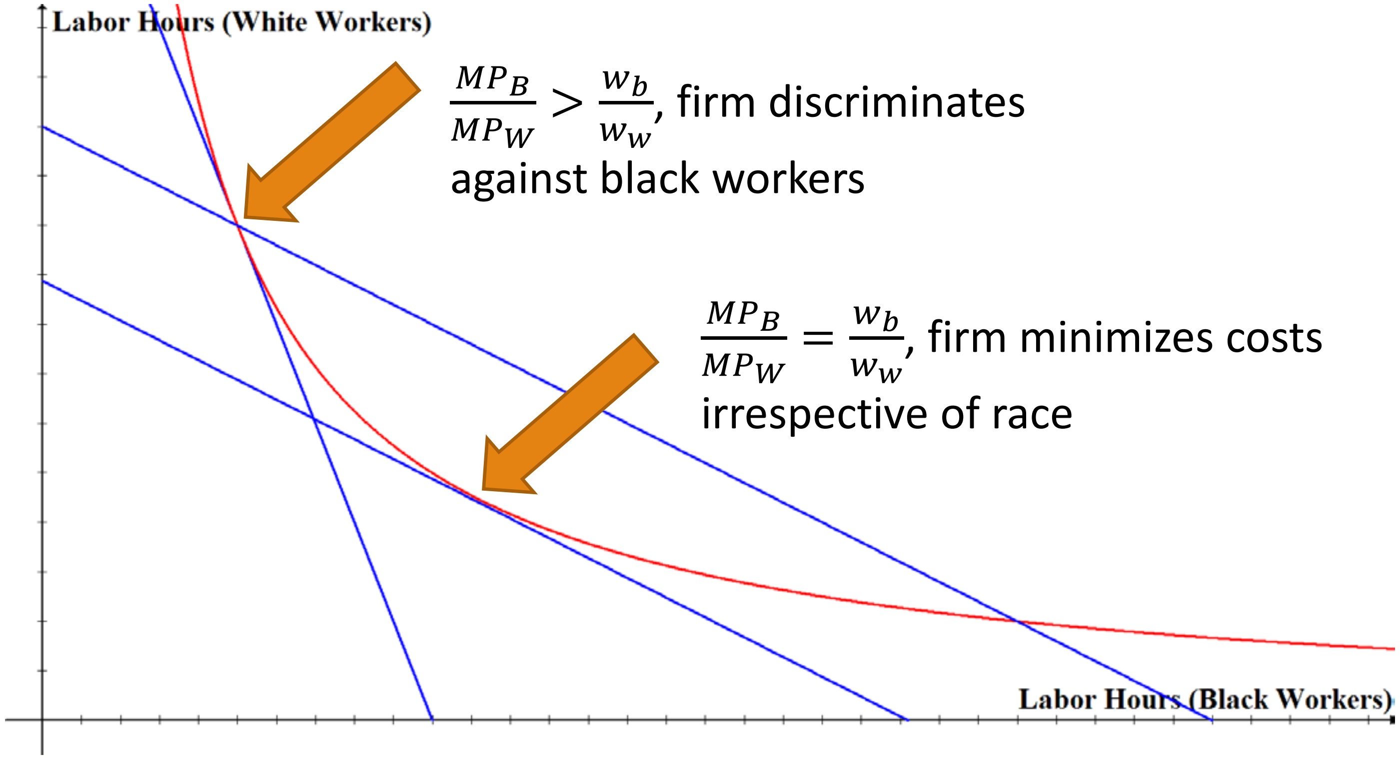
Extension: discrimination and why it tends to be inefficient

- It is conceivable that a firm will choose to hire more of one type of worker than is justified by their marginal products. That is to say that the firm discriminates between the two groups.
  - This could be based on a <u>manager's bias</u> or a law such as <u>affirmative action</u>.
  - In either case, the input combinations favor one group over the other based on non-productive considerations.
  - It could be gender, ethnicity, age, height, or any other characteristic unrelated to productivity.

Discrimination (continued)

- Say that production depends on the number of hours worked by two different groups: black and white workers. A firm that minimizes costs will hire workers such that RTS equals the wage ratio.



Discrimination (continued)

- A firm that discriminates hires workers *as if* they have to pay one group a higher wage than in reality.
- Look at the tangency at the combination for the discriminating firm on the graph. It is steeper than the isocost lines.
  - The firm behaves as if the relative wage of black workers is higher than it really is . . . and consequently hires fewer of them.
- The firm is incurring too much cost for a given level of output.
  - Note that the discriminating firm is on the higher of the two parallel isocost lines.
  - In this manner, the firm is "paying" for its bias with lower profit levels.

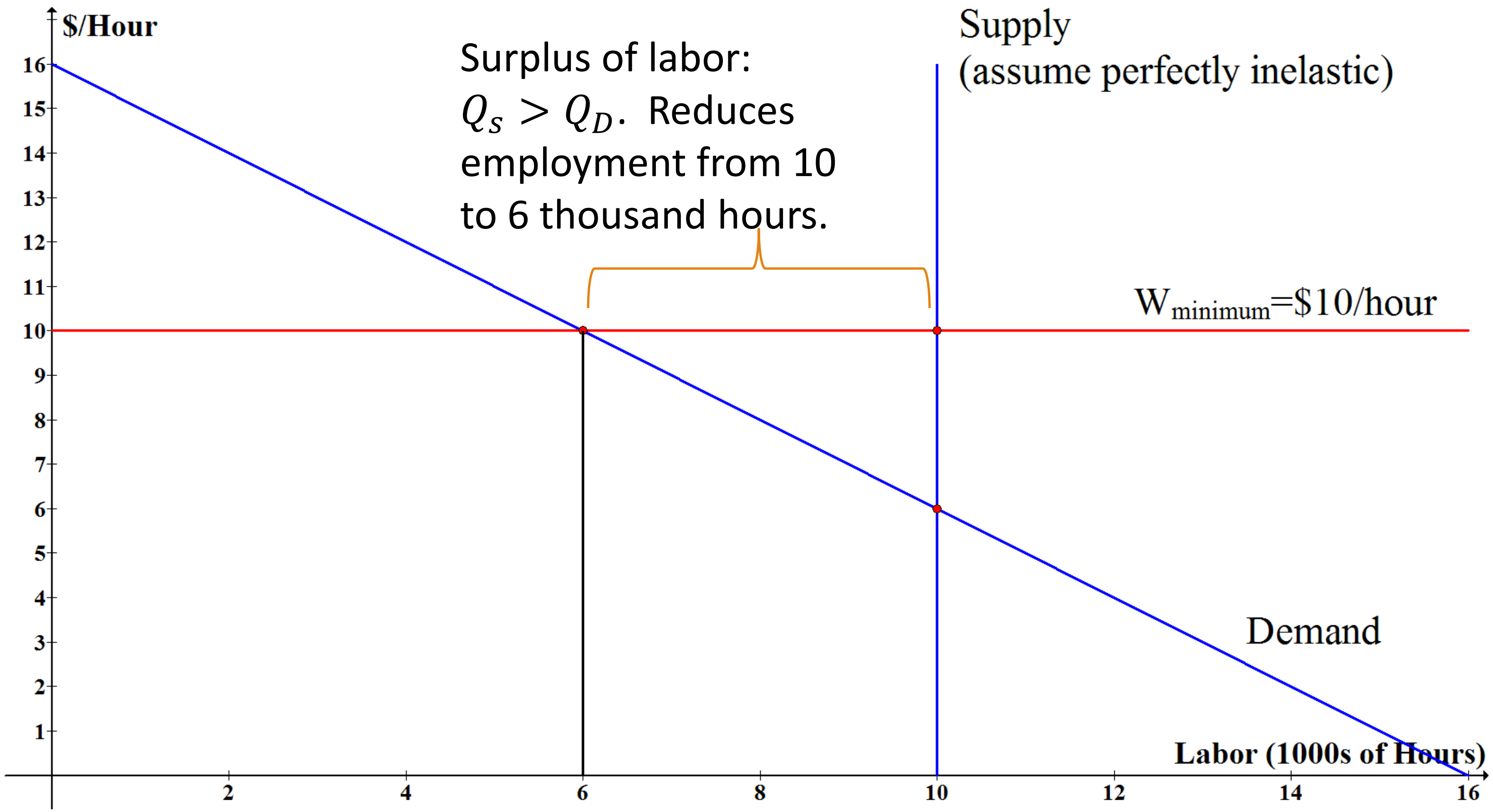
Discrimination (concluded)

- Whenever there are other firms that do *not* discriminate, they will be more profitable than their discriminating peers—especially if they can hire the un-favored group of workers at depressed wages.
  - Firms that discriminate against workers based on non-productive traits in a competitive market will be outcompeted by non-discriminating firms and fail. "Affirmative Action" type regulations can only hasten this outcome—not improve upon it.
    - However a well-crafted Affirmative Action regulation requires knowledge of the cost minimizing combination of black and white workers.
    - This is almost impossible for a policy-maker to know. If a binding AA regulation is enacted for a firm that already has the right combination of workers, it will decrease profit rather than enhance it.
  - The value of AA regulation is crucially dependent on the degree of discrimination present in the labor market. A subsequent lecture is devoted to exploring how this phenomenon is measured.

Extension: minimum wage regulation (and why it is inefficient in a competitive market)

- Recall the chapter in Principles of Microeconomics that dealt with price floors. A minimum wage is one of the most commonly cited examples of a price floor—a legal minimum price that can be charged for a good (in this case, labor).
- When the labor demand and supply interact, there is a market equilibrium, with employment level, E^*, and wage, w^*. A binding minimum wage is a legal minimum set above w^*.
- Minimum wage laws have also been criticized because of its failure as an anti-poverty tool (its assumed objective). This stems from the large fraction of minimum wage workers that are dependents, i.e., young and/or part-time workers. Many minimum wage workers belong to households that are not poor, so the efficacy of the minimum wage at reducing poverty is dubious.

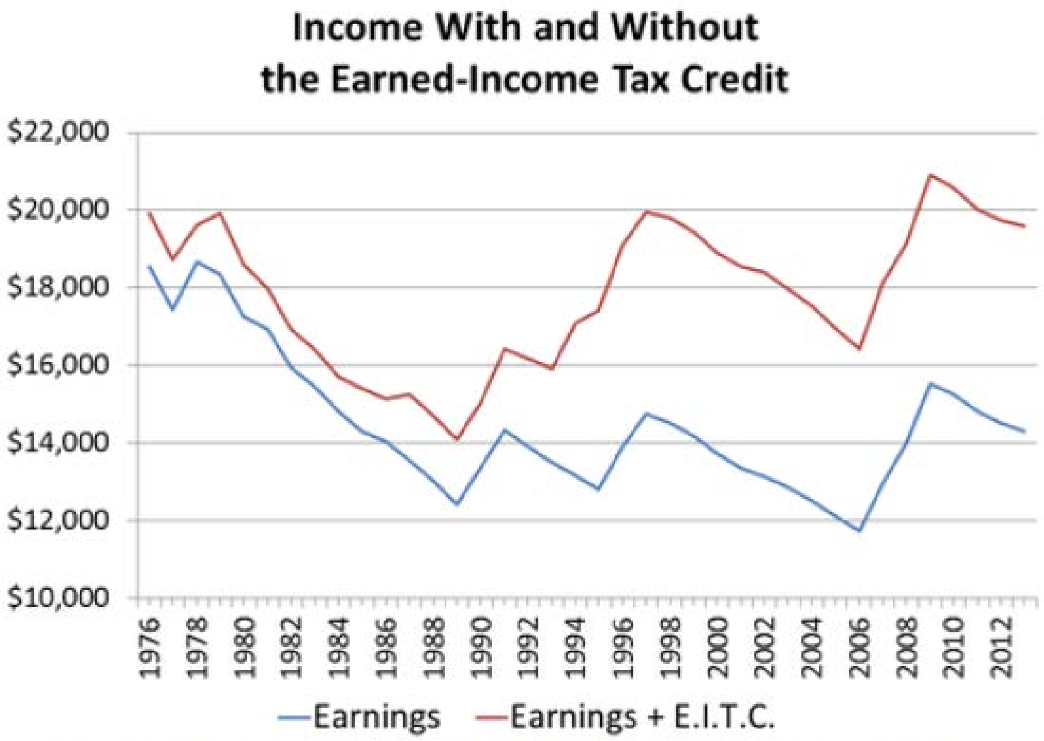
Minimum wage (continued)



Minimum wage (concluded)

- With a binding minimum wage, there is a surplus of labor, also referred to as unemployment. I.e., there are more people willing to work than firms are willing to hire at that wage.
- Contrary to the objective of the policy (raise wages for the least skilled workers), this displaces low-skill workers while raising the wage only for those who retain a job.
  - Evidence that some of the added cost is "passed through" to consumers with higher prices.
- Economists often compare the effect of the minimum wage (unfavorably) to another anti-poverty policy, the Earned Income Tax Credit.
  - This policy can be illustrated using workers' budget constraints, and we will discuss it in the next lectures on Labor Supply.
  - Since the 1990s, the EITC has increasingly replaced the minimum wage as the instrument for raising the incomes of low-wage workers.

Minimum wage and EITC



Figures are for a one-earner household working at minimum wage for 2,000 hours, in 2012 dollars. Source: Tax Policy Center and author's calculations.

Source: Neumark, David. "The Minimum Wage Ain't What It Used to Be." *NY Times* Economix column.