The Labor Market

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Econ520

January 31, 2024

Issues

▶ We move from the short run to the medium run

Short run:

- supply is elastic; we don't have to worry about it
- only demand matters
- Medium run: supply depends on prices
 - price setting mechanisms push output towards trend
 - demand and supply matter
- Long run: output is on its trend growth path
 - only supply matters
 - capital stock is endogenous

Objectives

In this section you will learn:

- 1. How do labor supply and labor demand "work".
- 2. How is employment determined when wages are flexible. Why aggregate demand is irrelevant in that case.

Next, we make wages sticky.

- ► Then aggregate demand affects employment.
- ► The model becomes useful for analyzing business cycles.

Labor Demand

Basic idea:

- Firms hire labor until real wage equals marginal product of labor.
- ► The last worker just pays for themselves.

The labor demand curve is the *MPL* curve.

Labor demand is determined by technology.

Firm's Hiring Decision



Marginal profit from hiring one more worker: $MPL_i \times p_i - W$

Example: Cobb-Douglas

Cobb-Douglas production function:

$$Y = \bar{A}K^{\alpha}L^{1-\alpha} \tag{1}$$

Parameters:

▶ productivity \overline{A} ▶ "capital share" $\alpha \in (0,1)$

Graph...

Example: Cobb-Douglas

The firm hires labor until $W = MPL \times p$ or real wage

$$w = W/p = MPL \tag{2}$$

The *MPL* is given by

$$MPL = (1 - \alpha)\bar{A}K^{\alpha}L^{-\alpha}$$
(3)

Everything else equal, the wage is downward sloping in L. Labor demand shifters are technology parameters (\overline{A} and α) and K. Graph...

Deriving MPL

$$Y = \bar{A}K^{\alpha}L^{1-\alpha} \tag{4}$$

Then

$$MPL = dY/dL = \bar{A}K^{\alpha} \times \frac{dL^{1-\alpha}}{dL}$$
(5)

Recall:

$$d\left(L^{1-\alpha}\right)/dL = (1-\alpha)L^{-\alpha} \tag{6}$$

$$MPL = (1 - \alpha)\bar{A}K^{\alpha}L^{-\alpha}$$
(7)

Constant Labor Share

In the Cobb Douglas case:

$$w = (1 - \alpha)\bar{A}K^{\alpha}L^{-\alpha} \tag{8}$$

Labor income

$$wL = (1 - \alpha)\bar{A}K^{\alpha}L^{-\alpha}L = (1 - \alpha)Y$$
(9)

The labor share wL/Y is constant at $1 - \alpha$

Constant Labor Share

Exhibit 2

Three-fourths of the decrease in labor share in the United States since 1947 has come since 2000.

The accelerating decline in labor share in the United States

https://conversableeconomist.blogspot.com/2019/05/why-did-us-labor-share-of-income-fall.html

Labor share of nonfarm business sector,1

- Raw - Filtered

Total compensation share of gross value added, %



¹ Detrended using Hodrick-Prescott filter (restriction parameter = 6); adjusted for self-employed income (non-farm business sector, 75% of total economy), from Labor Productivity and Costs database, Bureau of Labor Statistics.

Source: BLS (March 2019 release); McKinsey Global Institute analysis

Until recently, the labor income share has been constant.

Labor Demand

Labor demand is determined entirely by technology.

So are wages!

Note what does **not** matter:

Wages in other countries.

Our wages are not set in China

- We study later why not...
- Aggregate demand

Shouldn't the demand for goods shift the demand for labor?

Firms hire less labor in a recession than in a boom...

Why doesn't aggregate demand affect labor demand? For a single firm *i*:

- $w/p_i = MPL_i$ where p_i is the firm's own price
- \blacktriangleright higher demand for its good \Longrightarrow

For the economy as a whole:

 \blacktriangleright higher demand for all goods \Longrightarrow

Labor Demand



Firm *i*'s demand rises: $P_i \uparrow \Longrightarrow N_i^D \uparrow$ All firms' demand rises: $P \uparrow \Longrightarrow N_i^S \uparrow$ Key: labor demand and supply shift by the same factor (the rise in P).

Summary

Labor demand is simply the marginal product of labor. Completely determined by technology.

▶ and institutions that affect productivity (regulation, ...)

But wait ...

Labor demand falls in recessions because there isn't enough demand for goods!

The AS/AD model clarifies what's really going on there.

sticky prices play a key role

Labor Supply

Labor Supply

How does labor supply change with real wages?

Simple intuition: get paid more \implies work more.

substitution effect

But would you really work a lot of hours if you were paid 100,000 per hour?

income effect

A Simple Model of Labor Supply

Households choose labor supply just like consumption

► recall the discussion of the MPC

Household maximizes lifetime utility

$$\sum_{t=1}^{T} \left[u(c_t) - v(l_t) \right]$$
(10)

subject to the lifetime budget constraint



Notes:

- \triangleright v(l) is the disutility from working *l* hours
- the budget constraint assumes no discounting (zero real interest rate)

Digression



This assumes a zero **nominal** interest rate.

With a zero real interest rate, we get (11) on the previous slide.

Labor Supply Model

Lagrangian

$$\mathscr{L} = \underbrace{\sum_{t=1}^{T} \left[u(c_t) - v(l_t) \right]}_{\text{objective}} + \lambda \underbrace{\left[\sum_{t} \left(c_t - \frac{w_t}{p_t} l_t \right) \right]}_{\text{constraint}}$$
(13)

Households choose

- \blacktriangleright consumption c_t for all t
- lacktriangleright hours worked l_t for all t

Consumption Choice



First order condition for consumption:

$$\frac{\partial \mathscr{L}}{\partial c_t} = 0 \implies u'(c_t) = \lambda \tag{15}$$

Consumption Choice

$$u'(c_t) = \lambda \tag{16}$$

Interpretation ...



Consumption smoothing

- with zero real interest rate, the household wants constant consumption
- ▶ rich household \implies high c_t for all $t \implies$ low λ
- regardless of real wage profile

Labor Supply Choice

First order condition for labor supply:

$$\frac{\partial \mathscr{L}}{\partial l_t} = 0 \implies v'(l_t) = \lambda \frac{w_t}{p_t}$$
(17)

where $\lambda = u'(c_t)$.

Interpretation:

- An additional hour of working costs marginal utility v'(l)
- lt earns w/p units of income, each worth λ

Hours smoothing

- If real wages are constant, households want constant hours worked.
- ► Rich household \implies high $c \implies$ low $\lambda \implies$ low hours.
- Leisure is a normal good.

Transitory wage increase

$$v'(l_t) = \lambda \frac{w_t}{p_t} \tag{18}$$

Transitory rise in w/p leaves lifetime income roughly unchanged.

Consumption rises just a little in each period.

- λ approximately unchanged
- Labor supply in this period rises unambiguously
 - substitution effect

Refresher: income and substitution effects

Permanent wage increase



(19)

Lifetime income rises $\implies \lambda$ falls

 \triangleright c_t rises a lot in all periods

Income effect

smaller increase in labor supply compared with transitory shock
 Labor supply could even fall when wages rise permanently.

Labor Supply: Long-run Trends



For long-run trend wage growth, income effects win.

Labor Supply Curve

Key takeaways:

- wage increases have two opposing effects on labor supply
- ▶ substitution effect: N^{S} ↑
- ▶ income effect: $N^{S} \downarrow$
- the longer the shock lasts, the more important income effects become

For our model, we assume:

- labor supply is upward sloping in the wage
- because we focus on transitory wage changes
- but we keep in mind that wages may not affect employment in medium run

Labor Supply Curve

What shifts labor supply?

Think

$$v'(l_t) = \lambda \frac{w_t}{p_t} \tag{20}$$

where $\lambda = u'(c_t)$.

Not visible here (because we assumed zero real interest rate):

- Higher interest rates cause households to postpone leisure (and consumption)
- Hours rise.

Implications

$$v'(l_t) = \lambda \frac{w_t}{p_t} \tag{21}$$

How does labor supply vary over the business cycle? How does the answer depend on the persistence of business cycle shocks? Labor supply is mainly determined by preferences

but also by transfer payments (income when not working)
 Short-run labor supply is increasing in wages

substitution effects

Long-run labor supply is roughly independent of wages

big income effects

Recap Questions

- 1. Do transitory wage shocks affect labor supply more or less than persistent shocks?
- 2. Should high earners supply more or less labor than low earners?
- 3. Do labor income taxes reduce labor supply?

Labor Market Equilibrium

Labor Market Equilibrium



Labor demand is just technology (*MPL*) Labor supply is just preferences

Change in labor demand



Aggregate demand for goods does not affect employment There is no "real" unemployment

everyone who wants to work at going wages has a job

The solution: sticky wages

► AS/AD model...

Blanchard / Johnson, Macroeconomics, 7th ed, ch. 7 "The Labor Market" $% \mathcal{T}_{\mathrm{r}}$

Further Reading:

► Jones, *Macroeconomics*, ch. 7.