Revisiting Labour Markets: Implications for Macroeconomics and Social Protection

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1 Introduction

Labour represents the productive energy of human beings and labour markets, broadly defined, represent the institutions that channel this energy throughout society. Therefore, labour and labour markets are of paramount importance to the functioning of any economy. Yet, the theories that dominate the formulation of economic policies reflect an imagined world that bears little resemblance to employment dynamics on the ground. The consequences of this elaborate fiction are not trivial. The ways in which labour markets are conceptualised determines, to no small extent, the outcomes predicted by macroeconomic models, the perceived scope for social protection, and the potential for purposeful interventions to improve material wellbeing. This article explores the fundamental issues at stake in theorising labour markets and explains why a failure to rethink labour markets would compromise the development of meaningful macroeconomic and social policies.

2 Labour markets and macroeconomics

Macroeconomic predictions critically depend on how the labour market is theorised. If we change the conceptualisation of the labour market, we change the nature of the macroeconomy. This, in turn, has enormous implications for formulating macroeconomic policies and for evaluating their welfare impacts with regard to employment, average living standards, and the distribution of the value of output.

The intellectual history of macroeconomics is filled with examples of the intimate relationship between labour markets and the predictions of macro-theory. Keynes' critique of the 'Classical Economics' is a case in point. Classical economists, such as Pigou, argued that expansionary policies would have no long-run impact on the level of employment and, as a consequence, the real value of output (Pigou 1968: 248–51). According to Pigou, labour supply dynamics ensure that real wages rise in response to the heightened level of aggregate demand, preventing an overall increase in the level of employment.[1] More contemporary macro-theories, including those of the New Classical literature, echo this earlier logic. In contrast, Keynes argues that labour supply responds to money wages while labour demand reacts to real wages (Keynes 1964: Ch. 2). Under these assumptions, both labour demand and labour supply will increase in response to expansionary policies, leading to a higher equilibrium level of employment and output. A central debate in macroeconomics – can expansionary policies affect employment and real output – hinges on the nature of the labour market.

In macroeconomic models of developing countries, a surplus labour market is often assumed, along the lines of the one described by Lewis (1954). In contrast to both Classical and Keynesian models, labour supply is perfectly elastic in a labour-surplus economy. Formal sector employers draw from a reserve army of labour without bidding up wages. The 'surplus' workers are engaged in informal, subsistence or survivalist activities. Expressed another way, the surplus labour model treats informal employment as an undifferentiated residual with no barriers to entry. Under these conditions, non-labour constraints (e.g. a scarcity of capital) determine the level of economic output and formal employment. Expansionary macroeconomic policy will only impact output and employment to the extent that it relaxes the binding supply-side constraint. Again, the effectiveness of macroeconomic policy depends, to a significant extent, on the presumed nature of the labour market.

The point is not to debate the relative merits of the Classical, Keynesian, Lewis, or any other competing labour market model and choose the best of the lot. Instead, these examples illustrate a basic proposition: macroeconomic relationships depend on how labour markets are theorised and the nature of these relationships has significant consequences for policy analysis.

This discussion provokes a follow-up question: If good macroeconomics relies on a proper conceptualisation of the labour market, which labour market model is the correct one? None of the models discussed here fits the bill. For example, studies of informal employment in developing countries suggest that, contrary to the surplus labour approach, informal activities are heterogenous and barriers to entry limit labour mobility within the informal economy and between formal and informal forms of employment. The Classical and Keynesian models presuppose a dominant wage labour market, but in many countries self-employment cannot be ignored. An alternative framework for theorising labour markets is needed; one that reflects the actual relationships and employment structures observed. Unfortunately, a comprehensive theory along these lines remains underdeveloped.

3 The tyranny of the perfectly competitive labour market

The dominant strategy currently in vogue among policymakers is the pursuit of 'labour market flexibility' to realise higher levels of employment and improved rates of growth. Labour market flexibility is a catch-all term for a withdrawal of state regulation, for a shift away from social protections which ostensibly introduce market distortions, and for a reduced role for collective action, specifically on the part of trade unions and other worker organisations. The rationale for adopting this strategy of flexibility–liberalisation rests on the ideal of the perfectly competitive labour market – in which employers and employees have complete freedom to voluntarily establish optimal employment relationships in a competitive environment. Any movement away from this ideal distorts the functioning of labour markets and will lead to a misallocation of productive resources – ultimately producing slower growth and lower levels of employment, or so the argument goes.

The perfectly competitive labour market model, as formulated in neoclassical theory, has enormous implications for macroeconomic and social protection policies. Under its influence, macroeconomic policies become impotent in altering real economic outcomes, since employers and workers respond rationally to policy changes so as to keep employment at its 'natural' or market-clearing level. Social protection policies that affect labour market dynamics, for example minimum wages or certain forms of employment insurance, create distortions that, by definition, reduce aggregate welfare.

The idea of a perfectly competitive market is also implied in many dualist approaches to labour market dynamics and informality. In one variation of the dual labour market, distortions in the formal labour market cause job opportunities to be rationed. Those who cannot find formal sector jobs work informally. Since barriers to informal employment are assumed to be non-existent, informal labour markets more closely conform to the competitive ideal, although crowding in informal employment may push informal earnings lower than they otherwise would have been.

The perfectly competitive model makes for pat policy solutions, but it firmly belongs to the realm of theoretical make-believe. Non-regulatory market failures are legion in all labour markets. For example, for the perfectly competitive labour market model to exist at all, transaction costs must be zero (Kaufman 2007; Jacobsen and Skillman 2004). However, labour market participation involves real costs in terms of time, effort, and financial resources. Employers incur costs when filling vacancies, managing human resources, and monitoring their workforces. The informally self-employed often face costs in securing viable workplaces in urban centres or accessing markets.

The neoclassical model assumes that labour markets are complete in the sense that all contingencies can be identified and specified in an employment contract, and that such contracts are costlessly enforceable. Incomplete markets and imperfect information cause employment outcomes to deviate from the perfectly competitive ideal and can affect the distribution of power in economic transactions

(Shapiro and Stiglitz 1984; Bowles 1985). In efficiency wage models, for example, the prevailing wage rate is kept above the market clearing level in order to elicit greater effort from the workforce. Put another way, when productivity and earnings are correlated, there may be limits to profitable wage reductions on the part of employers.

In the perfectly competitive model, employed workers are indifferent to remaining in their current employment situation. Market clearing guarantees that they can find employment in an equivalent position if they choose to leave. In reality, workers are usually fearful of losing their jobs. Individuals are not faced with an endless stream of offers for equally lucrative opportunities. When real earnings fall – for example, due to unexpected inflation or an economic setback – most workers do not quit, they may even buckle down and work harder (Kaufman 2007). When working people place a value on remaining in their current position, employers enjoy a degree of market power when negotiating the conditions of employment (Manning 2003). An asymmetric distribution of power violates the assumptions needed for perfect labour markets to exist.

Issues of power are also relevant for the informally self-employed. For example, self-employed individuals engaged in subcontracted production operate in a competitive environment but depend on a large buyer for market access. This creates an asymmetric distribution of market power which determines the distributive dynamics of the relationship (Milberg 2004; Heintz 2006). Similarly, informal retailers may depend on a single large supplier for the goods they sell, leading to a similar unequal distribution of market power. These types of market failures are not caused by excessive government intervention, but rather emanate from the institutional setting in which informal employment relationships operate.

On the labour supply side, workers often face barriers to entry and limitations to mobility due to segmented labour markets. Researchers working in the tradition of dual labour markets have long accepted that labour markets are divided into formal and informal segments, with barriers to mobility between the two. However, labour market segmentation can also exist within informal forms of employment (Günther and Launov 2006; Chen *et al.* 2005). If informal employment is segmented, it complicates the mainstream analysis of informality. Segmentation implies heterogeneity within the informal economy and, therefore, the concept of informal employment as an undifferentiated residual must be rejected. Similarly, segmentation of informal employment implies barriers to entry that exist even when formal regulations and social protections are absent.

Labour supply behaviour – for example, the decision whether to participate in the paid labour force – frequently deviates from the predictions of neoclassical theory. According to the standard model, workers make a choice between the marginal satisfaction they get from more employment income and their enjoyment of additional leisure time. As average earnings increase, the implicit cost of leisure rises, and more time is dedicated to paid employment. Labour supply therefore rises and falls with the wage rate.

However, empirical studies have documented an increase in labour force participation – particularly among women – when average real earnings have fallen (McKenzie 2004; Aslanbeigui and Summerfield 2000; Cerrutti 2000). This suggests that labour supply and earnings may be negatively correlated, particularly among low-income households (Spencer 2006). Faced with lower earnings, household members increase their labour supply in an effort to make ends meet. This occurs because households must meet the fixed costs of their basic needs (housing, food, energy, etc.) if they are to sustain and reproduce themselves. Neoclassical models – by focusing exclusively on marginal changes and decisions modelled at the individual, not household, level – assumes away the fixed costs of maintaining households as social institutions. Joan Robinson provides an early critique of neoclassical labour supply models in her writings:

> The individual breadwinner without private means can never be in a position to refuse to work because real wages are too low to be worth the effort. He must earn what he can get or starve … It is commonly found that hours become longer and the number of workers in a family greater as real wage rates fall.
> (Robinson 1937: 11–12)

This article has focused on the shortcomings of the perfectly competitive labour market model at some length, largely because the implications are so critical for macroeconomic and social policies. If we reject the perfectly competitive model of neoclassical economics, macroeconomic policy has the potential to influence real outcomes – including the level of employment, the quality of remunerative work, and long-run economic performance. Similarly, appropriate social protection policies – even those that directly affect labour market dynamics – have the potential to enhance welfare. Moreover, barriers that prevent informal workers from maximising the return they get for their labour can be acknowledged to exist and appropriate responses formulated based on relevant research. This in no way suggests that currently existing labour market regulations are necessarily the most desirable or that there are no constraints to macroeconomic stimulus. Rather, it is being argued here that a policy framework founded on an unreformed neoclassical labour market model will likely reach erroneous conclusions.

In addition, if real labour markets differ substantially from the standard neoclassical model, then pursuing an agenda of labour market flexibility can produce perverse outcomes. For example, removing labour regulations and rolling back social protections could cause an increase in labour supply – if such actions squeezed household resources. Similarly, there may not be a strong employment response, if contracts are imperfect and there are limits to profitable wage reductions. The net result of labour market flexibility could be a rise in unemployment (due to greater labour force participation) or growing informality. This outcome is not necessarily inevitable nor does all labour market reform generate unintended consequences but, to adequately assess the impact of increased 'flexibility', we need a credible framework for understanding how labour markets work.

Ironically, models of imperfect labour markets abound in the economics literature, and not just among heterodox practitioners or the radical fringe of the discipline. Despite a well-developed critique, even among many in the mainstream, rarely do these theoretical insights alter the dominant policy prescriptions in a meaningful way. The integration of informal employment and appropriate social protection remains underdeveloped. The critiques, such as those developed by the so-called 'New Keynesians' and other, less orthodox, economists dedicated to establishing the limits of markets, explain why markets fail to work as expected. These writers, however, have been less effective at developing an array of policy alternatives, based on a rethinking of labour markets, that gels into a coherent framework.

One additional challenge concerns the term 'labour markets' itself. Often labour markets refer exclusively to wage labour markets, in which an employer hires an employee for a specified wage. This approach excludes the self-employed and effectively drives a wedge between the idea of labour markets and a comprehensive treatment of employment.[2] This article defines the concept of labour markets broadly to include the set of all institutions that influence the conditions and terms under which labour is exchanged. Many of the self-employed – particularly if we exclude employers and focus only on own-account workers – are effectively selling their labour services, since labour is the dominant factor of production these workers have at their disposal. However, the value of labour services provided by the self-employed is realised through other market transactions, apart from the wage labour market. The broader definition of labour markets proposed here includes all employed persons whose employment income is predominantly comprised of the returns to their labour, regardless of whether these returns are realised on a wage labour market or through some other transaction.

One implication of adopting a broader definition of labour markets is that the conceptual framework based on the dichotomy of 'labour demand' and 'labour supply' may no longer be universally operational. For example, in the typical demand/supply framework, the self-employed must be considered both buyers and sellers of their own labour. This could be interpreted to imply that the self-employed are economic schizophrenics, at war with themselves as to where their self-interest lies. More to the point, it suggests that the traditional apparatus for theorising labour markets – with its intersecting supply-and-demand curves – will need to be reformed to adequately capture the employment relationships that dominate the labour markets of developing countries.

4 Labour as a produced factor of production

An often-heard mantra is that macro-policies should create an environment conducive to sustainable long-run growth. But how is long-run growth theorised and where does labour fit in?

In the first generation of neoclassical growth models, capital is the only produced factor of production (Solow 1958). A certain fraction of output was set aside for investment in capital goods. The resulting growth equilibrium was depicted as a steady-state in which the amount of output saved for investment was sufficient to keep the capital stock growing in proportion to other factors of production (e.g. labour). The growth rate of the other factors of production – which often included an abstract variable for technology – were exogenously determined. Endogenous growth theory extended the basic Solow model and introduced technology as another produced factor of production (Romer 1990). Labour remained exogenous to the model. Other models include human capital as a produced factor of production, in which individuals could make productive investments in their own skills and education (Mankiw *et al.* 1992). Yet again, the workforce itself was determined by dynamics outside the market economy.

Workers do not spring into existence, fully formed and ready to toil. Real economic resources go into producing human beings. The economic inputs include marketed goods and services (a fraction of gross domestic product (GDP) is dedicated to raising children) and non-market goods and services (such as those produced with unpaid care work). The coordination of these inputs to produce human beings takes place in numerous settings and institutional forms, including the household, public institutions (e.g. schools), kinship networks, communities, and markets (e.g. for food, shelter and paid care). How well these institutions do at producing quality human beings will have an impact on long-run economic growth. In short, labour should not be treated as exogenous in macroeconomic models – it too is a produced factor of production.

Treating labour as a produced factor of production allows social protection, and more generally social policy, to contribute to the macroeconomics of long-run growth. Many of the institutions responsible for producing human beings are themselves the objects of social policies – including educational and health services. Social protections for working people have an impact on the production of human potential. For example, well-designed maternity and paternity leave policies can change the allocation of resources to support better child outcomes by mitigating labour market penalties. Similarly, public childcare programmes help resolve work–family conflicts. Social insurance programmes for both formal and informal workers can protect income when a family member falls ill and therefore help sustain households in the face of an unexpected shock. In short, social policies and social protections can contribute to macroeconomic performance, but it requires a change of mindset in which the production of human resources becomes integral to the functioning of the economy.

5 Employment and the distributive consequences of macroeconomic policies

In recent years, much attention has been paid to the idea of 'pro-poor growth' – that is, growth which reduces poverty or disproportionately benefits the poor.[3] The central innovation of the pro-poor agenda, relative to policies that simply strive to maximise growth, is that the distributive consequences of a policy regime must be taken into account. Most people receive the majority of the income required to sustain themselves and their dependants through some form of employment. Moreover, the factor of production which most poor households command in abundance is labour. Although age, disability and illness create labour shortages in specific cases, most low-income households are not labour-constrained. They are more likely to be constrained in terms of access to other productive resources such as land, capital, financial assets, public infrastructure, and skills. Therefore, anything that raises the returns to labour will raise living standards of the poor and thereby reduce poverty.

The capacity to achieve 'pro-poor growth' depends on the structure of employment, the nature of labour markets, and relationship between macroeconomic policy and employment outcomes. For example, growth does not always yield more formal sector jobs – as countries that have experienced bouts of 'jobless growth' have demonstrated. Equally important, faster growth may not translate into reduced poverty in highly segmented labour markets. When poor workers face barriers to their mobility, they may be unable to take advantage of new employment opportunities that arise.

Similarly, the supply-side impact of macroeconomic policies depends on the nature of existing productive relationships. Expansionary policies that increase demand can also have an impact on the supply-side. Consider an informal street trader. Her productivity is determined by the quantity of retail services she supplies within a given time period. However, the supply of retail services is demand-constrained. Raise aggregated demand and the productivity of many informal workers increases. Greater productivity leads to higher returns to labour and, ultimately, results in 'pro-poor growth.'

These examples suggest that achieving 'pro-poor growth' and designing macroeconomic policy regimes that reduce inequalities require a realistic understanding of the structure of employment and the functioning of labour markets. Under the assumptions of the perfect labour market – whether they are called Classical, neoclassical, or New Classical – fiscal and monetary policies have no supply-side effects, barriers to entry do not exist, and full employment is obtained in the absence of government interference. This implies that any liberal growth regime will be pro-poor, provided that it is not accompanied by market distortions. However, when we deviate from this ideal form, there is greater scope for economic policies to specifically target distributive outcomes – and to entertain the possibility that distributive outcomes can impact macroeconomic performance.

6 A call for action

This article has argued that how we conceptualise labour markets will profoundly influence our understanding of macroeconomics, growth, and social policy. The theory of labour markets represents a contested terrain and the current imperial ruler appears to be the neoclassical perfectly competitive model. This is unfortunate, since other approaches exist, are compelling and hold great promise. Perhaps the most critical challenge is to unite these alternatives into a common, coherent framework – and then insert this new approach into macroeconomic models and social policy analysis. The end result would be transformative. Clearly, there is an enormous need to revisit our thinking about labour markets – the stakes are too high to allow the current situation to continue. Therefore, this article concludes with a call to action – to marshal the collective energies of dedicated researchers, theorists, and scholars to formulate an innovative approach to 'real' labour markets that promises to change the way we think about economic policy.

Notes

1 For example, Pigou writes about the labour supply response (i.e. 'real-wage rates stipulated for, by workpeople') to expansionary fiscal policy as follows: 'But eventually wage-rates may be expected to adjust themselves to the new demand situation and, when they have done so, the benefit to employment will be exhausted' (Pigou 1968: 248, 250).

2 Often, the self-employed are classified as 'entrepreneurs' or 'producers' and not 'workers'. However, the concepts of an 'employee' and an 'independent contractor' are closely related and can be arbitrary. Firms can choose to hire employees to perform a set of tasks or to contract out the same set of tasks to an independent contractor. *Ex post*, the same set of labour services may be exchanged, although the institutional form of the exchange is different. Simon (1951) argues that wage employment will be dominant as an institutional form when both employers and employees find it advantageous to agree upon a wage in advance but allow the employer discretion to dictate the future activities to be undertaken, subject to certain limits. In contrast, a contracting relationship will dominate when it is advantageous to specify the services to be provided in advance (e.g. as is the case with industrial outwork and other modern forms of subcontracted production).

3 These two definitions of 'pro-poor growth' are not equivalent.

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