Econ 101 No Longer Explains the Job Market

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Noah Smith April 5, 2018

The battle over the effects of minimum wages has been one of the most protracted and bitter fights in the history of empirical economics. Some researchers, such as David Neumark of the University of California-Irvine, continue to insist that pay floors kill jobs, and a few studies find negative effects. But a series of very careful, large-scale studies is finding that the minimum wage is as benign as its advocates have suggested.

One of these is a study by economists Doruk Cengiz, Arindrajit Dube, Attila Lindner and Ben Zipperer, which looked at state-level evidence and found no negative effect of mandated pay increases on employment. They found that minimum wage hikes tend to decrease the number of jobs just below the new cutoff, but increase the number above the line -- implying that the wage hike isn't killing jobs, but simply giving people raises.

Now, Kevin Rinz and John Voorheis, a pair of researchers from the U.S. Census Bureau, have an even more comprehensive study with even more detailed evidence. Looking at data on individual earners from 1991 through 2013 -- a very long time period -- the authors take careful account of factors like mobility and transitions into and out of the labor force. They find that minimum-wage increases tend to raise incomes for people at the bottom of the distribution, and that the effect doesn't fade with time. Meanwhile, they find that the probability of people losing their income entirely -- i.e., unemployment or dropping out of the labor force -- isn't significantly affected by minimum-wage increases.

This evidence is about as good as we're likely to get, and it is likely to be highly persuasive. On his blog, my Bloomberg View colleague Tyler Cowen wrote:

> On the pro-minimum wage side, you should consider that those immediately affected by the wage hike do seem better off, and their higher income in the meantime may itself bring some efficiency-enhancing gains.

But the importance of this research goes beyond its implication for minimum-wage policy. Along with other research, it's forcing us to rethink our basic understanding of how labor markets work.

The standard framework that economists traditionally used to understand job markets is just supply and demand, the theory taught to every introductory econ student. But since the 1990s, a steady drumbeat of empirical results has led to questions about that simple model's usefulness.

First, economists found that even very large, sudden waves of low-skilled immigration didn't hurt the wages of native-born Americans, as the theory suggested should happen when there's a positive shock to labor supply. Adjusting the model to match this reality

wasn't too hard. Economists just had to assume that immigration produces a positive shock to labor demand as well as supply -- immigrants buy things locally, creating jobs for the native-born.

But the minimum-wage effect posed more of a problem to the theory -- no matter how you slice it, price controls should lower employment in a competitive market. The likeliest reason that this doesn't happen is that employers have market power -- that it's so costly and difficult for workers to find new jobs that they simply accept lower wages than they would demand in a well-functioning market. If employers have market power, modest minimum-wage rise will tend not to increase unemployment, because they force companies to move back toward the wage levels that would prevail if competition were working the way it should. In that model, a small increase in minimum wage could even increase the number of jobs.

New evidence is showing that employers have more market power than economists had ever suspected. Two papers -- the first by José Azar, Ioana Marinescu, and Marshall Steinbaum, the second by Efraim Benmelech, Nittai Bergman, and Hyunseob Kim -- find that in areas where there are fewer employers in an industry, workers in that industry earn lower wages. The two papers use very different data sources, look at different time periods and different geographical units, and use different statistical methodologies. But their findings are completely consistent.

Together with the evidence on minimum wage, this new evidence suggests that the competitive supply-and-demand model of labor markets is fundamentally broken. If employers have the power to set wages, then not just minimum wage, but other labor market policies -- for example, union-friendly laws -- can be expected to help workers a lot more than popular introductory economics textbooks now predict.

Textbook writers and instructors should respond by changing the baseline model of labor markets that gets taught in class. Students ought to start with a model of market power, in which a few companies set wages below levels found in a competitive market unless prevented from doing so. That model is about as easy to work with as the traditional supply-and-demand setup, but matches the data much better.

In any scientific discipline, theories should evolve as new evidence comes in. That's true both of what gets used in research and what gets taught in class. The evidence on labor markets has evolved, and the dominant theories need to change with the times.

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To contact the author of this story:
Noah Smith at nsmith150@bloomberg.net

To contact the editor responsible for this story:
James Greiff at jgreiff@bloomberg.net