CHAPTER II

LABOUR MARKET THEORIES AND THEIR VERIFICATION

2.1. Introduction:

Human wants are infinite, but the resources available to fulfil these desires are finite. Since a finite entity cannot match an infinite one, the mismatch is everlasting. A sound economic management should, therefore, strive to reach the second best alternative, i.e., to ensure that the available resources are utilized fully and most efficiently. Of all categories of available resources, labour enjoys a special status for various reasons such as: it is a human resource; its power is perishable; it can organize itself into unions; and its unemployment can cause social and political upheavals. Its full employment is thus not only economically desirable but also socially and politically imperative.

2.2 Neoclassical Theory:

How do we ensure full employment? The neoclassical prescription is “inaction is better than action”. The labour market (and, for that matter, any factor market) is no different from the product market in its basic features. As any product market is
labour market. Thus, given the flexibility of wage-rates, the demand for labour would always be equal to its supply in the long run. In the short run, there could be some frictional unemployment because of the time taken in job-searches and lack of information but, ultimately, equilibrium would be restored: The short-term fluctuations would tend to correct themselves. Trade unions and the state intervention (in the form of labour laws, minimum wages acts, employment guarantee schemes etc) are not facilitators to ensure full employment; in fact, they are hindrances to this process. The neoclassical analysis is based on a partial equilibrium as they believe in the dichotomy of the financial market and real markets. Money is assumed to act only at a medium of exchange and a unit of account.

2.3. Keynesian Theory:

Keynes, on the other hand, rejected this partial equilibrium approach. He pointed out that a fall in wages was likely to reduce household spending which, in turn, would reduce total spending in the economy. This deficiency of spending would cause unintended inventory build-ups for the producers. They would then revise their production decisions downward and employ fewer people. This might set in another round of involuntary unemployment which
This might set in another round of involuntary unemployment which would lead to a further fall in wages and so on. The economy would then be caught in an economic depression. Wages-flexibility is no remedy to ensure full employment. A reduction in household spending should, therefore, be matched by additional spending by somebody else. Producers may not be willing to oblige when as they find unsold stocks piling up at the shop floor. The state should, therefore, come forward to bridge this gap.

The Keynesian prescription rests on active state-intervention in a market economy. Keynes, thus, advocates guided capitalism by which the onus of ensuring full employment in the economy devolves on the government. The Keynesian recommendation of an expansionary fiscal policy is well known in this regard. "since maintenance of full employment required existence of aggregate demand at a compatible level which might not always be forthcoming on its own through uncoordinated actions of private entrepreneurs and consumers, the gap would have to be made up through excess of government's investment expenditure over its revenue receipts in this respect public finance policy became an appendage of employment policy and not merely a device to raise
revenue for financing essential expenditure of the State” (Mathur, 1998, p.16).

This Keynesian prescription was widely administered in many economies—developing as well as developed—after World War II. The short-term consequences of state-sponsored increase in aggregate demand were encouraging as employment opportunities increased. But, by the 1970s, the long term effects of such a strategy forced economic thinkers to take a fresh look at it. The growing public debt (caused by government expenditure exceeding its revenues) and deficit financing, created another macroeconomic problem—inflation—that, in due course, became even more bothersome than unemployment. Post-Keynesians are once again questioning the efficiency of ‘guided state capitalism’ as suggested by Keynes and advocating laissez faire. There is a qualitative change in the role of the state. Instead of an active player in the

mechanism, State intervention and trade unions are being

From a purely theoretical point of view labour market can be defined as “a process by which supplies of a particular type of
labour and demands for that type of labour balance or seek to balance". Through this adjustment mechanism a market clearing wage is attained. Thus, labour market can be defined as those mechanisms and institutions through which the purchase and sale of labour power is arranged. However, an adequate analysis of labour market would have: (i) to take into account non-wage labour (and so the mechanisms of access to a production capability in self-employment); (ii) to look at labour market structure and outcomes in the context of struggle over shares in income; (iii) need to consider the disparities in job contents and career structures as well as in wage and employment levels; and (iv) to look at both social and economic relationships involved in the supply and use of labor.

The problems arising from differences in skill requirement and labour quality are resolved by supposing that labour productivity results partly from natural endowment and partly from investment in human capital. The market signals for 'quality' labour, and labour adjusts itself by increasing human capital investment (either by foregoing current income or acquiring funds in a perfect capital market) to raise its productivity and hence its price. By contrast Marxian labour market theory links the mechanism of the
labour market to the system of power and domination in society at large.

2.4 Marxian Theory:

Moreover, as Marx puts, there must be constantly be an unemployed reserve army of labour to keep the supply of this commodity abundant and its price low. So, according to this reasoning the most important condition for development of capitalism in its middle stage is the existence of an industrial reserve army which exerts enough pressure from the 'external' market on the 'internal' market to keep down wages inside the factory or workplace. Thus, the assumption that, at any point of time, there is a tendency of the supply of labour and demand for labour to balance at a given wages seems unrealistic. Apart from this, other neoclassical models - 'signaling', 'job competition' and 'human capital' - have been unable to satisfactorily explain the structure and functioning of labour market in advanced industrial economies. These models while explaining the labour market experiences of different participants put much emphasis on development of individuals. For example, human capital model states that an individual's position in the labour force depends primarily on the amount "invested" in that individual. So like an
economy, an individuals growth in the labour market can be analysed in terms of a production possibility curve, available resources and prices of these resources.

2.5 Human Capital Theory:

Proponents of human capital theory have explained the unequal distribution of labour income in terms of differential amount of human capital like education, experience, training necessary behavioural traits, etc. possessed by different individuals. While doing so, they have tried to establish a positive functional relationship between the earnings of an individual in the labour market and the amount of human capital the individual owns. It follows that the human capital theory puts much emphasis on the supply-side of the labour markets thereby, to a greater extent, undermining the importance of demand-side factors. This theory thus turns to be a partial approach to labour market analysis.

Though, these theorists have succeeded in empirically verifying most of the human capital hypotheses, they fail to explain the economic-political implications of structured labour markets. Also, they have not succeeded in answering the question as to why individuals having otherwise equal potential human capital are
rewarded differentially in the labour market (at least, in certain specific labour market segments.)

At this juncture, in late 1960s, a rich non-neoclassical theory of labour market analysis was evolved to fill the voids in the explanations of labour market structure and functioning. This goes under the rubric of “labour market segmentation”. However, it should be noted that the theories of labour market segmentation did not come as threats to neoclassical labour market theories in general and human capital theory in particular, rather they came as complementary to neoclassical theories of labour market. The existence of segmentation in the labour market-defined as different wages for workers of equal efficiency—are regarded as imperfections resulting in a misallocation of resources. These are recognized to exist both in “in-market” (in the form of the monopoly power of labour and the monopsony power of capital) and “out market” (in the form of non-competing groups) situations, and are generally condemned. But such imperfections are considered by neoclassical theorists to be of marginal importance compared with the “deep silent strong stream of the tendencies of normal distribution and exchange”. (Marshal, 1952).
The function of the labour market is to match people to jobs. Not all people are equally suitable for a given job, nor are all jobs equally suitable for a given person. So far as the suitability of a person for a job is concerned, there are certain individual characteristics which must be taken as fixed- notably age, sex and ability- and some which can, at some cost, be changed- notably the individual's skills and place of residence. So far as the suitability of a job for an individual is concerned, there are certain aspects of the job specification which are difficult to change, such as the type of work to be done and the industry in which it is to be carried on. Other aspects are more easily changed, notably the skill required of the worker and the location of the job. We may therefore visualize the labour market as matching a labour force characterized by age, sex and ability to jobs characterized by occupation and industry, the matching being effected through training and through the relocation of industry and labor.

A labour market is efficient if it satisfied two main criteria. The first is that of allocative efficiency, which means that each worker would be employed in the occupation to which he is most suited, in terms of his occupational preferences and his comparative
advantage with respect to other workers. The second is that of full employment, which means that each worker willing to work at the wage currently paid to individuals of similar skills can find suitable employment. It is well known that both types of efficiency are achieved by a competitive market economy operating under ideal conditions.

Allocative efficiency is achieved by a system of wage differentials. Given a structure of differentials, the market allows employees to reveal their preferences for one occupation over another, and employers to reveal their preferences for different types of skill. If when aggregated by the market the plans of employers and employees are inconsistent, the wage differentials are adjusted by competitive forces until they become consistent. With the resulting system of differentials no worker is willing to exchange occupations and no employer wishes to substitute skills.

2.6. Theory of Search:

The theory of search unemployment emphasizes (a) that the choice of a suitable job requires a great deal of information if alternative employments are to be properly appraised, (b) that information in the labour market is usually incomplete, so that
searching for information about jobs is a valuable activity, and (c) that search activity is often better carried on full time rather than part-time.

Two types of information are relevant to job choice: namely, the nature of the job—the effort involved, the skills required, and so on—and the remuneration—the rate of wages, promotion prospects, occupational pension, and so forth. In a perfectly competitive labour market it can be assumed that all employers in the same area will offer the same remuneration for the same job. But in practice lack of information among workers may encourage some employers to discriminate against the uninformed by offering low wages to those unaware of alternative job opportunities. In such cases there are gains to searching not only across occupations but also across employers, in order to obtain the most favourable wage quotation.

The appropriate strategy of job search depends on the type of information sought. Consider first the search for information on wages. For most manual or low-paid jobs the wage is usually announced when the vacancy is notified; in order to search for information it is sufficient to scan classified newspaper advertisements, visit employment exchanges, or just telephone
around. For professional or highly paid jobs the wage is normally negotiated, usually after the applicant has been interviewed; in this case wage search is a more time consuming process.

Obtaining information on the nature of jobs is usually more difficult than obtaining wage quotations. The worker can search extensively, by collecting summary information on a large number of jobs, using advertised job specifications, brochures, and so on, or intensively, sampling a few jobs in depth— for example, by working at them for a probationary period. The strategy adopted will depend on the strength of the job-seeker's preferences for a particular type of work, and on how much he already knows about alternative occupations. Normally, extensive search will proceed intensive search. Extensive search can usually be carried on part time, while intensive search is typically a full-time occupation.

2.7 The Theory of Structural Unemployment:

The theory of structural unemployment is based on a disaggregated view of the labour market. The market is regarded as a collection of sub-markets for different levels and types of skill. The theory assumes that different skills have low elasticity of substitution in both demand and supply. In other words, it is difficult for an
employer to substitute one skill for another in carrying out a particular job, and it is equally difficult for a worker trained in one skill to adapt readily to another.

In a changing economic environment, where some industries are growing and others are in decline, it is difficult to maintain each labour sub-market in equilibrium. With free markets wage differentials would adjust, encouraging employers to take on the more abundant types of labour, and workers to switch into occupations where demand is greatest. But in practice two factors usually prevent this. The first is institutional fixing of wage differentials, considered in the previous section. The second is the inadequate provision of training, which inhibits the transfer of workers between occupations.

There are good grounds for arguing that there is under-provision of training in the private sector. The absence of transferable property rights in trained labour means that workers cannot easily mortgage their future income to finance their own training. In practice the prospective employer may be willing to finance it, provided that he can 'lock in' the trainee until he has repaid the costs of his training out of increased productivity. There are various ways
of locking in employees: offering pensions which are forfeited on quitting, giving low interest mortgages which have to be repaid, and so on. However, none of these methods offers the employer full security, and to the extent that the risk of quits cannot be eliminated the employer will be reluctant to invest in training.

Just as institutional constraints restrict the mobility of workers between occupations, so they also restrict mobility between locations. Many industries are tied to particular areas, because of reliance on local raw materials and specialized transport networks. For this reason changes in industrial structure often lead to regional imbalances in growth. The readjustment of the working population through migration is inhibited by the natural reluctance of workers to break social ties. But, in addition to this, institutional factors deter movement. Nationally negotiated wage rates prevent regional wage differentials from reflecting the relative scarcities of labour. The need to wait for council housing and the loss of continuity in children’s schooling both create problems in moving. Thus, even if the under provision of training could be resolved, there would still be problems of structural adjustment arising from obstacles to the geographical mobility of labour.
2.7 Implications for the incidence of unemployment:

Each of the preceding theories has implications for the incidence of unemployment in different groups. At any one time the following groups will be much more strongly represented among the unemployed than they are among the working population as a whole.

1. Workers who overestimate the general level of wages and prices prevailing in the economy. Such workers are likely to stipulate too high a money wage, and will therefore be unable to obtain suitable offers of employment.

2. Workers who are reluctant to adjust their expectations in the light of search experience. Such workers will tend to continue longer in unemployment before they can find a job which meets their expectations; hence their duration of unemployment will be long.

3. Workers with little knowledge of the nature of alternative jobs, or those undecided on a career. Such workers will search intensively for jobs, sampling each for a probationary period until they find one which suits them. Their frequency of job-changing will be high.
4. Workers who are subsidized (by either their family or the state) while unemployed. Their loss of earnings owing to unemployment is relatively low, and this encourages them to remain unemployed longer than they otherwise would.

5. Wealthy workers who can maintain consumption standards while unemployed. By dissaving— for example, by liquidating assets such as building society deposits—workers can finance themselves through a period of unemployment, and avoid being forced to take the first available job to satisfy immediate consumption needs.

6. Workers seeking employment in trades where wages are artificially high. When wages are above the competitive level, workers are encouraged to wait rather than accept a job in a low-wage occupation.

7. Workers who wish to enter trades in which there is under provision of training and who are not sufficiently adaptable to take alternative work, given that institutional arrangements prevent these workers from bidding down wages, they may become structurally unemployed.