In the nine years since the appearance of the first edition of Stephen Smith’s book, labour economics has become a more firmly entrenched subject on the curriculum. Previously regarded as a subsection within industrial economics, there are now very few universities that do not devote a course to it in its own right. The focus of topics covered within it has also altered – the notion of human capital has now become much more central and microeconomic considerations are now as widely studied as macroeconomic phenomena.

The 2nd edition will address these changes and give greater centrality to microeconomics to reflect current course teaching. The book adopts an international focus and covers important themes such as:

- labour demand and supply
- wage determination and unions
- personnel economics
- unemployment and globalisation.

With features such as case studies, end of chapter questions, further reading sections, this new edition will prove popular with all students of labour economics.

Stephen Smith is at the London Metropolitan University, UK.
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I wish to thank Rob Langham at Routledge for asking me to write this second edition; thanks also to Terry Clague for seeing it through to completion.

Many thanks to all those who kindly read, used, reviewed and above all bought the first edition! This includes the many cohorts of students taking the E0303 module in Labour Market Economics at the old University of North London, especially those who said, ‘The book was more interesting than I thought it would be’ and ‘You write exactly how you speak in lectures!’ Praise indeed. A big thank you to my colleagues in the Economics Department, including John Sedgwick, John Curran, Photis Lysandrou, Tony Mananyi, Craig Duckworth, Gugliemo Volpe, Brian MacAulay and Bob Morgan for their kindness and willingness to take on a lot of extra teaching and administration during 2001/2002.

Once again I have drawn heavily on the support of Angela Bradding and our sons Adam and Ashley. I have also benefited from the close friendship of so many people, including Dr Iain Williamson, Nigel and Bev, Dr Mike O'Donnell, Tony and Julie, Dr Robert Wimperoy and Ronan and Ivan. Heartfelt thanks also go to the staff of the hospitals at La Spezia and Rapallo, Italy. Particularly I would like to thank Drs Paolo Pantaleo and Alessandro Bellisario at Villa Azzurra, Rappallo, who put me back in working order during August and September of 2001.

Finally I owe a large debt of gratitude to the late Norman Stang, who was largely responsible for getting me started on an economics teaching career.

The publishers would like to thank Edward Elgar, Blackwell Publishing and Oxford University Press for permission to reproduce material within the book. We would also
like to thank the staff at Felix Rosentiels Widow and Son Limited and Sefton MBC Leisure Services Department, Atkinson Art Gallery for permission to reproduce the wonderful Street Scene, *Southport* by L.S. Lowry on the front cover.

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Stephen Smith
Introduction

Labour economics is now a well-established, distinct area of specialisation within the discipline of economics. The purpose of this book is to provide students encountering labour economics for the first time, yet possessing a knowledge of intermediate undergraduate economics, with a grounding in the specialism. This should enable the student to participate in the discussion of labour market issues from a more informed perspective and will provide them with the confidence to tackle 'state of the art' journal articles and research papers in the area. It covers the significant topic areas of labour economics with a combination of pure theory, economic statistics, summaries of important empirical studies and discussions of labour market issues and policies.

The emphasis is very much upon providing an accessible survey of the content of labour economics. We will identify how the market forces of labour supply and labour demand interact. We will demonstrate how that interaction determines wages. The book introduces personnel economics as an application of labour economics concepts. We need to examine the quality of labour and how this may affect the growth performance of economies. When we consider trade unions as a labour market institution, we will concentrate on their links with output, inflation, productivity and unemployment. Job search and vacancies will be analysed in relation to unemployment. Finally we will be concerned with an aspect of industrial decline, deindustrialisation, as we examine how international trade and globalisation have affected labour markets. Thus, whilst essential theories are explained, the main thrust of the book is to apply such theories to examine issues relevant to the understanding of unemployment.

Explaining the phenomenon of persistent, mass unemployment remains as important a challenge to economists in the 2000s as it did in the 1930s when Keynes (1936) was incorporating an explanation of unemployment into his 'General Theory'. Unemployment lies at the core of labour economics and, as such, is a coherent theme.
which runs throughout this book. We are therefore engaged in an analysis of why
the labour market does not appear to clear at anything like a full employment
equilibrium.

The use of the term ‘labour market’ should not be taken to indicate that we believe
there to be a single, integrated auction house for human factor services. Quite the
contrary, labour markets can be delineated and subdivided according to numerous
criteria, of which geography and occupation are only the most obvious. The labour
market is an important theoretical construct of which we will make full use through-
out this book. Yet bear in mind that actual markets for human factor services are
decentralised, fragmented, imperfect markets whose actors are heterogeneous, bur-
dened by limited information, and subject to significant transactions costs.

In order to conduct an analysis of the labour market we need to abstract from the
complexity of labour market outcomes the crucial elements of the behaviour of eco-
nomic agents. In seeking to understand labour market activity, the labour econo-
mist theorises as a means of simplifying the complex web of interactions that occupies
this aspect of human action. The most pervasive theory of the labour market is the
neoclassical theory of labour supply and labour demand interacting to determine an
optimal combination of wages and employment. This theory represents a good start-
ing point for a textbook on labour economics because it is consistent with the
microeconomic analysis found in the traditional theory of the firm and the analysis of
consumer behaviour. It also provides a foundation upon which we can build empirical
aspects of labour markets. It is a background against which we can examine theoret-
cal extensions such as job search, screening and human capital. And it can be used to
inform our discussion of unemployment, the impact of trades unions and the role of
Government labour market policies.

Although our analysis is rooted within the neoclassical framework, this does not
mean that more recent developments such as principal–agent relationships, efficiency
wages and the insider–outsider distinction will be ignored. Such developments which
challenge the standard neoclassical approach will be incorporated where appropriate
throughout the book. Thus, for example, the chapter on discrimination will examine
segmented labour markets. Our treatment of unemployment will include the distinc-
tion between insiders who are in work and outsiders, those without jobs. The chapter
on trade unions will cover principal–agent relationships within the bargaining pro-
cess. Students will also recognise the use of Coase’s notion of transactions costs in our
treatment of labour demand. This approach to these new concepts in a labour market
context is guided by the desire to integrate them into our attempt to understand the
labour market, rather than to isolate them as an awkward postscript to our neoclassically
based modelling.

The book will also endeavour to reflect, in small measure, contributions to labour
market analysis from nonneoclassical schools of thought within economics. It will
do so by combining in an eclectic fashion elements of different schools of thought.
For example, the chapter on globalisation contains the essentially post-Keynesian, deind-
ustrialisation thesis as a labour demand topic. Perspectives on unemployment as diverse
as Keynesian and New Classical economics will be represented. The importance of institutional factors on labour market outcomes will also be emphasised; the power of trade unions; the legislative framework with regard to discrimination; and the arrangements for welfare payments to the unemployed.

STRUCTURE OF THE BOOK

Although this book has been written with students specialising in labour economics in mind, we have deliberately kept the level of technical complexity down to a minimum. Consequently it can be read by those interested in human resource management, especially Chapters 3–8. Chapter 10 will be of interest to all concerned with understanding the problem of unemployment. Each chapter contains a short summary which highlights the main features of the topic area, along with some suggested questions for discussion, designed to gauge the reader’s understanding of the subject and a couple of important readings on the topic.

The first two chapters establish the basic model of the labour market with the forces of labour supply and labour demand interacting to determine real wages and employment. Our theoretical treatment in both chapters is supplemented with relevant statistics on labour supply, labour demand and productivity with applications geared towards explaining the phenomenon of unemployment. In Chapter 1, the supply-side view of unemployment is related to an understanding of the theory of labour supply. In the case of labour demand (Chapter 2), we examine the productivity performance of the UK given the links between productivity and unemployment. Chapter 3 brings labour supply and demand together to determine wages. We are concerned to explain trends in wage inequality and discuss the merits of minimum wage legislation.

A distinguishing feature of this edition is the explicit treatment that personnel economics receives in Chapter 4. Personnel economics deserves to be examined in its own right because of the growing interest in issues such as providing incentives at work, the role of non-monetary fringe benefits and debates about the pay of chief executive officers. Chapter 4 also introduces the important concept of internal labour markets.

Chapter 5 contains the influential economic explanation of how labour productivity can be enhanced by investing in human capital acquisition. New growth theories emphasise the importance of human capital’s contribution to the growth and development of economies. Education is an important process by which the quality of labour can be improved, with differences in educational attainment explaining significant and enduring wage differentials between workers. We also examine the provision of work-related training. The chapter looks at whether growing wage differentials between the skilled (more highly educated and trained) workers and their unskilled colleagues, plus higher unemployment rates for unskilled workers, might be due to technological change and specifically how the introduction of computers has favoured skilled workers.
The fact that wage differentials between groups of workers remain after accounting for differences in human capital investment provides the spur for the economic analysis of labour market discrimination to be found in Chapter 6. Beginning with sex discrimination, neoclassical and alternative segmented market theories of discrimination are set in the context of persistent wage and employment differences between males and females. We attempt to assess the impact of equal opportunities legislation and consider the likely effect of moves towards policies based upon the principle of comparable worth. We also look at a model of racial discrimination and examine the labour market experiences of immigrant workers.

Chapter 7 deals with trade unions as a potentially powerful labour market institution. We look at aspects of union power, examining the theoretical as well as the empirical evidence about the impact of organised labour on output, productivity, inflation and unemployment. There appears to be a strong case supporting adverse union effects on unemployment, although the magnitude of those effects is contentious. It seems likely that the impact of trade unions will depend upon the bargaining environment in which they operate. We discover that trade unions are a force for greater equality in labour market outcomes.

The influential concept of labour market flexibility is set out in Chapter 8. Various aspects of flexibility are covered and progress towards greater flexibility, particularly in UK labour markets, is examined. We also find out that labour market flexibility could well be a crucial ingredient for the success of European Monetary Union which introduced the Euro as a fully operational currency in January 2001.

Job search theory provides a microeconomic, supply-side explanation for unemployment. Chapter 9 highlights the importance of the welfare benefit regime in influencing the job search activity of the unemployed. However, it may well be that the most important aspect of benefits, in an unemployment context, is their duration rather than their generosity or the lack of it. The role of vacancies in the labour market is often overlooked; thus while the path unemployment has taken over time may be well known, knowledge of the changes in available jobs is likely to be scant. In Chapter 9 vacancies form an integral part of our analysis of unemployment. We are able to establish that the relationship between vacancies and unemployment has deteriorated markedly since the 1960s in the European Union (EU) countries, yet much less so in the USA. A feature of the rise in EU unemployment since the 1960s has been a dramatic decline in the rate at which people leave the unemployment register. This could be linked to job search by the unemployed. Certainly in the UK the link between unemployment and vacancies improved markedly during the 1990s.

Chapter 10 draws together a number of the observations we were able to make about unemployment in the earlier chapters. Descriptive statistics provide a picture of the unemployment problem against which to sketch out the main theoretical approaches to unemployment: the Classical; Keynesian; Monetarist; and New Classical schools of thought. However, through the concept of hysteresis, the self-generating property of unemployment, particularly with regard to the long-term unemployed, leads us to Layard et al.’s (1991) eclectic theory, which examines unemployment
under conditions of imperfect product markets, unionised workforces and differing welfare benefit regimes. The empirical performance of this model is impressive and it points to the importance of increasing the centralisation of wage bargaining, reducing the duration of benefits coupled with quality education and training, employment subsidies and even public sector work placements as policies to combat unemployment. We attempt to assess the effectiveness of such policies in reducing the waste and misery caused by persistent mass unemployment.

Chapter 11 examines the impact of the growth of international trade and increasing integration of the world economy (globalisation) on labour markets. We focus on the deindustrialisation thesis because of the light it may shed on the rapid rise in unemployment, particularly during the recessions of the early 1980s and early 1990s, which was common to all the advanced industrialised economies. We conclude that although unskilled workers in basic manufacturing may have been vulnerable to globalisation, this has not been the main cause of their declining relative wages and increasing unemployment.


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