

More sellers than buyers

Alan Manning has been looking at the weaknesses of the classical model of market competition in explaining the behaviour of the labour market and argues that we should learn lessons from the monopsony model.

Countries tend to be judged successes or failures by their ability to deliver jobs to those who want them and an adequate standard of living. So labour markets are important. The vast majority of us are wholly dependent on the labour market for our livelihood. So how the labour market works and how it might be improved are also important.

Economists have had a lot to say on this subject. The default position of most of them is that, in the absence of government regulation, the workings of labour markets can be well approximated by the textbook model of perfect competition. In this idealised world, workers face a market wage for their labour that is equal to their productivity and a large number of employers, all competing for their services. In this world, if they found their employer attempting to lower their wages (even by 1p), the workers would all instantaneously walk out the door to seek employment elsewhere. Getting or losing jobs in this world is no big deal: they are everywhere.

This description of the labour market does not fit well with the way it is experienced by most of us. We go to the pub to celebrate when we get a

job and we go to the pub to drown our sorrows when we lose one. Surveys that ask people to name something important that happened in the last year typically find that job-related events are the second most important category, after family events like births, marriages, divorces and deaths.

Getting and losing jobs is a big deal to so many of us for the simple reason that it is not as easy to find work as the textbook model of perfect competition would have us believe. Finding work we like in a place and at a time convenient for us is hard. Information about jobs is not perfect and there are substantial costs involved in changing jobs. The other side of this coin is that our employers have more power over us than the model of perfect competition would have us believe. If an employer cuts our wages, it may be true that we are more likely to leave than before and that it will be harder for the employer to replace us, but it is simply not true that all of us would walk out immediately.

Employers are interested in profits and they use their power over workers to keep wages down wherever they can. Economists have another textbook model appropriate to this situation: it is called monopsony.

Monopsony means "a condition in

which there is only one buyer for the product of a large number of sellers". So it refers to a situation in which there is only a single employer available to buy the labour of workers. While the stereotype of a mill town or pit village in the early days of the Industrial Revolution might fit this definition literally, few workers today really only have one potential employer. But the lessons of the textbook model of monopsony apply wherever the opportunities of workers are finite.

I have just written a book, "Monopsony in Motion: Imperfect Competition in Labor Markets", arguing that our understanding of the workings of labour markets would be much improved if we adopted the commonsense perspective that employers have some monopsony power over their workers and abandoned the view that employers are powerless in the face of impersonal market forces. Much of

**Information
about jobs
is not perfect**

Interventions should be innocent until proven guilty

the book is devoted to documenting how this view of labour markets improves our understanding of a wide range of labour market phenomena. This should keep academic labour economists happy, but why is it anything more than an academic argument?

The reason is that one's views on how the labour market works affect one's view on the wisdom of various policy interventions. For, as Keynes over-quotedly observed in the General Theory: "The ideas of economists and political philosophers, both when they are right and when they are wrong, are more powerful than is commonly understood. Indeed the world is ruled by little else. Practical men, who believe themselves to be quite exempt from any intellectual influence, are usually the slaves of some defunct economist. Madmen in authority, who hear voices in the air, are distilling their frenzy from some academic scribbler of a few years back".

Today's scribblers are still hard at work: they can be found (among other places) on university campuses, in the pages of the Economist and in the reports of the OECD. Asked to analyse some labour market policy, the instinctive response of most labour economists is to fall back on the predictions of the textbook model of perfect competition.

If one thinks that labour markets correspond closely to the textbook theory of perfect competition, then one is likely to be hostile to interventions designed to remedy perceived deficiencies in its "free" workings. A famous result in economic theory tells

us that the outcome of a perfectly competitive market will be efficient, though there is no reason to believe it is fair. Any intervention in the labour market is rather grudgingly tolerated on the grounds of equity, though typically associated with mutterings about the efficiency costs. This presumption that the "free market" is efficient has a powerful hold over the minds of economists.

However, if one thinks that employers have some monopsony power over their workers, then one does not believe that the "free" market necessarily delivers an efficient outcome and one is inclined to be more sympathetic towards labour market interventions. This does not mean that any intervention is always to be considered good, just that there is no longer the presumption that it is always bad. Interventions should be innocent until proven guilty and not the other way round. To make all this more concrete, let us consider some examples from the past, present and future.

First, one from the past. Not many people argue these days that equal pay legislation should be abolished, but there was considerable controversy about it around the time of the introduction of the Equal Pay Act in 1970 and the Sex Discrimination Act in 1975. At that time, it was relatively common to hear economists argue that, if women earned less than men, that must be because they were less productive (because that is the only source of possible wage gaps in a perfectly competitive market) and that any attempt to artificially reduce the gender pay gap through legislation would inevitably result in women being priced out of jobs.

The simple reason why one does not hear this argument any more is that this prophecy of doom failed to come true. Although there is still a gender pay gap, it is lower now than in the past and the Equal Pay Act led to a noticeable rise in the pay of women relative to men: between 1970 and

1975 hourly wages for women went from 65% to 75% of the male level. There was no noticeable effect on women's employment, which continued to rise throughout this period. This would be a serious puzzle, if one believed that labour markets are perfectly competitive. It is not a puzzle, if one believes that labour markets are monopsonistic.

The "monopsony" approach suggests that one reason women get paid less than men is that the constraints imposed on their working lives by the allocation of domestic responsibilities in most households mean they are more vulnerable to exploitation by employers. In this case their pay can be raised without jeopardizing their jobs.

Second, an example from the present. Consider the case for and against the minimum wage. Surveys of economists typically find a large degree of consensus that the minimum wage is a bad policy, harming those it sets out to help by pricing some low-wage workers out of their jobs. In these beliefs, economists differ markedly from the general public, for whom the minimum wage is probably the single "left-wing" policy that commands the most support. The economists, as usual, are relying on the textbook model of perfect competition, where wages equal productivity. If wages rise faster than productivity, it will not be profitable for firms to employ the workers and job losses will result.

In contrast, the monopsonistic approach argues that, because employers will use their power over workers to pay them a wage below

Women's employment continued to rise

their productivity, there is some scope for raising wages without jeopardizing jobs. There is, of course, a limit to how much wages can be raised before job losses result: nice as the thought is, there is little doubt that a minimum wage of £50 per hour would cause serious economic problems. But, the modest levels for the minimum wage chosen in countries like the UK and the US do not seem to cause job losses among those affected.

Third an example from the future. The British government is currently resisting implementation of the EU's Working Time Directive, which would limit the number of hours that can be worked in a week. The argument is that, if workers want a shorter working week, the market can be relied upon to deliver it and so there is no case for intervention. But the monopsony approach suggests that, because employers make profits out of workers, they will always be pressing them to work more hours than they would freely choose. At the very least, we need to take a close look at the experience in Continental European countries with policies to reduce the working week before rejecting such legislation here.

Then there are the commonly accepted explanations of the widening gap in wages between rich and poor in countries like the US and the UK in the past twenty years. Seeing that wages in low-wage jobs are growing more slowly than those in high-wage jobs, most economists have concluded that the explanation lies in a shift in demand from low-wage to high-wage jobs. This shift in demand

is thought to be driven by changes in technology in general and information technology in particular. This widening gap in wage inequality is often regarded as an inevitable by-product of "progress" – of which we are all naturally in favour.

But this is not the only plausible story to explain what has happened. There turns out to be a close relationship in the US between the evolution of wage inequality and the level of the real minimum wage. In the 1980s, wage inequality rose sharply and the federal minimum wage fell in real terms, since it was left at the same nominal level. From the late 1980s there were three rises in the minimum wage, all associated with a decline in wage inequality that was then reversed as the real value of the minimum wage was eroded by inflation. There would seem a strong *prima facie* case that the minimum wage should be given a prominent role in explanations of US wage inequality and that the rising gap between rich and poor should be seen as the result of government policy, rather than inexorable technical progress.

But those who believe that the labour market is perfectly competitive just cannot accept this explanation. The reason is their faith that a rise in the minimum wage must price some low-skill workers out of jobs. The fall in the real value of the minimum wage in the 1980s should have priced some low-skill workers back into employment. But employment rates fell among these workers at this time.

If one accepts that the labour market is monopsonistic, then there is no mystery here. There is no particular reason to think that the minimum wage, set at modest levels, will cost any jobs at all. So it is quite possible to reconcile the view that the minimum wage was the main culprit in explaining the rise in wage inequality with the observation that employment rates of low-skill workers fell.

For the UK one cannot tell exactly the

These changes have lowered the floor to wages

same story about the rise in wage inequality because, for most of the last twenty years, we have not had a national minimum wage. But welfare benefits have only been increased in line with prices, not wages; trade unions have been in decline; and the Wages Councils, which set minimum wages in certain sectors, have been abolished. All these institutional changes act to lower the floor to wages in the labour market and can explain why low-wage workers have been doing so badly.

There is a theme that runs through all of these examples: the wisdom of particular policies cannot be judged by economists armed with nothing but some pet economic theories. They can only be judged by their effects. In many ways, this is in tune with the spirit of the times, which demands "evidence-based policy-making" and emphasises a pragmatic and commonsense approach to public policy, free from excessive ideological baggage.

It is time for labour economists to dump the comforting certainties that the textbook model of perfect competition appears to offer and to recognise that the world is a more complicated and messy place.

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His book "Monopsony in Motion: Imperfect Competition in Labor Market" will be published by Princeton University shortly.

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