

Labor Markets

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Labor markets have historically played an important role in the experience of poverty and the distribution of economic opportunity in the United States, shaping the overall availability of jobs as well as wage levels, benefits, and possibilities for promotion. Labor market theories have also been prominent as explanations for poverty, in part reflecting the work-centered nature of U.S. social welfare policy.

Labor market theories of poverty attempt to address three main questions. (1) Why is there unemployment and underemployment (in the sense of people unable to work as many hours per week or as many weeks per year as they choose)? (2) What accounts for the very different valuations, and consequent pay levels, of different jobs? (3) Why are some people—and in particular, some socially significant *categories* of people, such as women or people of color—more likely to end up unemployed or in low-wage jobs? For as long as there have been labor markets in the United States, economists and others have put forward two conflicting types of theories about the answers to these questions. On the one hand, some have argued that labor markets are basically efficient and, in some fundamental sense, fair. This viewpoint favors *supply-side policies*: policies that remove restrictions on labor markets and help individuals to invest in skills. For the last 100 years, the predominant theory associated with this point of view has been neoclassical economics. On the other hand, critics have claimed that labor markets are inevitably greatly shaped by institutions distant from efficiency considerations, and often distant from fairness as well. These critics have championed *demand-side policies*, favoring enlightened regulation of wage levels and hiring, and support for institutions designed to rectify power

imbalances, such as unions. Over the last century, the critical view has been linked to radical (including Marxist) and institutionalist theories.

A glance at recent poverty statistics establishes the link between labor markets and poverty in the United States. As Table 1 documents, adults who did no paid work in the previous year are far more likely to be in a household that fell below the poverty level than those who worked year-round, full-time. Part-time and part-year workers fall between these two extremes, though closer to those who did no paid work at all. Despite this ordering, it is important to note that close to three percent of year-round, full-time workers live in poverty households: sustained work at low wages can still leave a person (and his or her household) in poverty.

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Why is there unemployment and underemployment?

The average family in poverty worked a total of 1,112 hours in 1998—about half of the 2,080 hours that constitute year-round, full-time work for one person (Mishel, Bernstein, and Schmitt 2001, Table 5.18). While this low level of hours worked to some extent reflects deliberate choices (themselves influenced by other constraints such as child-rearing or disability), unemployment and underemployment also limit work hours for poor families and individuals.

Until a third of the way through the last century, the dominant explanation of unemployment was the classical view, holding that excessively high wages depress labor demand. The policy implication, which echoes down to this day, is that institutions maintaining higher wage levels, such as unions or minimum wage laws, harm employment in the aggregate.

Economists dismissed the possibility that aggregate demand might not be sufficient to absorb aggregate supply, citing Say's Law that "supply creates its own demand."

The Great Depression that gripped the industrialized world during the 1930s, and John Maynard Keynes's *General Theory of Employment, Interest, and Money* (1936), challenged this traditional consensus. Keynes argued that pessimistic expectations by capitalists, translated into anemic investment in plant and equipment, can become self-fulfilling, trapping an economy in a downturn. In these circumstances, Keynes argued, wage-cutting simply aggravates the shortfall of demand since it leaves workers with less money to spend on consumer goods. Instead, governments should use monetary policy (cutting interest rates) and especially fiscal policy (reducing taxes or expanding spending) to "prime the pump" of private consumer expenditure and to assure full employment. Governments, including that of the United States, implemented this theory through social welfare spending and public works programs. World War II and postwar "military Keynesianism" (military spending aimed at job creation) carried this policy thread forward, although Congress backed away from an explicit commitment to guarantee *full* employment embodied in early drafts of what became the Employment Act of 1946 (notably leaving out the "full" in the original title).

In the 1970s and 1980s, Keynesianism stumbled over the combination of stagnation and inflation in the United States (a possibility Keynes had discounted), as well as persistent high unemployment in Western Europe that many attributed to classical causes—high wages and generous welfare payments. "New classical" economists revived the classical analysis of unemployment (Barro 1989). Equally important, huge federal deficits in the United States (run up by early 1980s tax cuts combined with increased military spending) politically blocked proposals for substantial new tax cuts or spending programs, while anti-government rhetoric

undermined support for employment creation programs such as the 1973 Comprehensive Employment and Training Act (CETA). By 2000, deficits had been replaced by surpluses, and a wide range of new empirical and theoretical research questioned classical accounts of unemployment (notably Blanchflower and Oswald 1994, who found that unemployment tends to be associated with *lower* wages rather than higher). Nonetheless, new classical economics continued to reign on campuses, low unemployment at the outset of the 21st century blunted concerns about job creation, and a combination of economic recession and massive tax cuts soon recreated huge federal deficits, further constraining policy options.

Underemployment's most readily measurable form is involuntary part-time employment—workers stuck in part-time jobs against their wills. Families of involuntary part-time workers are more likely to fall below the poverty line than those of voluntary part-time workers, and both are far more likely to live in poverty than year-round, full-time workers. The causes of involuntary part-time employment are similar to those of unemployment. Indeed, fluctuations in the level of involuntary part-time employment track unemployment quite closely. However, involuntary part-time work has an added “classical” component, since employers typically offer part-time workers fewer fringe benefits and in some cases lower wages (Tilly 1996).

What accounts for the pay levels of different jobs?

\$6.05 per hour marked the upper bound of lowest paid 10 percent of U.S. wage earners in 1999 (Mishel, Bernstein, and Schmitt 2001, Table 2.6). If a person worked year-round, full-time at this wage, she or he would still fall \$700 below the poverty line for a family of three. Indeed, the family-wide average hourly wage of families in poverty in 1998 was just slightly higher, at

\$6.16 (Mishel, Bernstein, and Schmitt 2001, Table 5.18). At the other end, the lower bound of the highest paid five percent stood at \$33.28. The highest paid CEO in America in 2000, Citigroup's Sanford Weill, received \$224.4 million in direct compensation, which translates to about \$72,000 per hour (assuming a 60 hour week). Clearly, differing wage levels contribute to extremes of wealth and poverty in the United States.

The leading theory of wage differences, that of neoclassical economics, puts forward an elegantly simple explanation: people are paid according to their productivity—or more precisely, their *marginal revenue product*, meaning the amount that they add to sales. The reasoning behind this theory is straightforward. As firms add more and more labor to a fixed stock of capital (machines, buildings, and so on), the added product gained from each added hour of labor eventually declines. Since firms maximize profits, they will keep adding labor as long as the amount of saleable product yielded by an extra hour of labor exceeds the hourly wage—so that hiring one more hour of labor results in a net gain. They will stop adding labor precisely at the point at which the marginal revenue product equals the wage (see, for instance, Hamermesh 1986).

The question then becomes why some workers in some jobs are more productive than others. Neoclassical theorists point to two main factors: skill and the other resources a worker has to work with (for example, Baumol and Blinder 1991, Chapter 36). Note that skill has two kinds of impacts. Certain *jobs* require more skill and involve greater productivity, and therefore pay more. But even in two identical jobs, one *person* may bring more skill than another, and therefore be more productive and earn more. As for other resources, neoclassical analysts posit that workers using more capital (more or better machines, faster computers, and the like) can be more productive. They often cite low capital/labor ratios to explain low pay levels in less

developed regions. Similarly, workers with more able co-workers (better managers, more clever innovators) are more productive. The most important policy implication of this perspective is that wage differences are efficient. For example, firms offer higher wages to attract workers with higher skills, and the pay differential prompts workers to seek added education and training (Welch 1999). Neoclassical recommendations to reduce poverty include subsidizing the acquisition of general skills, and facilitating capital inflow to, or labor out-migration from, depressed areas such as mid-20th-century Appalachia.

Critical theorists take a different tack. Karl Marx himself concentrated primarily on the processes setting average wages for the working class, emphasizing workers' cost of subsistence and the class struggle. To the extent that he discussed wage differences, he accepted the neoclassical notion that they reflect skill differences (Marx 1967 [1867]). But Marx's contemporary John Stuart Mill (1929 [1848]) wrote of "non-competing groups" in the labor market for whom hiring and wages were governed by custom and institutions (such as guilds and professions), rather than market competition. Institutionalists in the United States, most prominently represented in the early 20th century by John R. Commons (1934), took Mill's proposition in two directions. They stressed the importance of institutions—including tangible organizations such as unions, but also more diffuse phenomena such as fairness norms—in regulating wages. And, more importantly for theorizing poverty, they picked up the idea of segmented labor markets.

For much of the 20th century, institutionalists, riveted by the momentous struggle to unionize the industrial workforce, focused broadly on how institutions affect wages. In the post-World War II years, however, renewed interest in issues of poverty and racial inequality sparked attention to segmentation, a term popularized by Peter Doeringer and Michael Piore (1971). The

labor market segmentation perspective challenges the neoclassical notion of smooth, continuous tradeoffs, holding that particular sets of characteristics or governing rules tend to be found together. This points to multiple, qualitative distinctions between good and bad jobs. Doeringer and Piore described the “secondary” segment as jobs marked by low wages, high turnover, arbitrary supervision, and often unpleasant working conditions (in contrast with well-paid, steady “primary” sector jobs). These are the jobs of the working poor.

Theories of segmentation have typically adopted either functional or historical logics. Functional accounts, like neoclassical wage theory, focus on efficiency. For instance, some view the job ladders that characterize certain segments as incentive systems. The promise of advancement can help to deter shirking, and to retain workers with valuable skills or proprietary knowledge. However, segmentation theorists appeal to history as well as efficiency. Historical accounts point to the enormous power of inertia enforced both by short-run efficiency (based in the familiarity of current ways of doing things) and the defense of vested interests. Sociologist Arthur Stinchcombe (1990, Ch.10) observed that many jobs still reflect the organizational forms of their era of introduction: a case in point is the craft structures of the building trades. Struggles along class, race, and gender lines also weigh in. Neo-Marxists David Gordon, Richard Edwards, and Michael Reich (1982) attributed the initial homogenization and later segmentation of the U.S. proletariat to employer efforts to assert control over their workforces—first by deskilling the workers and later, in response to industrial unionism, by dividing them.

Policy advocates have used segmentation theory to argue for policies quite different from those implied by neoclassical productivity theory. The goal is to shift employment from secondary sector jobs to primary sector jobs, either by directly regulating the labor market (through devices such as the minimum wage or unions) or by industrial policies subsidizing

better-paying “high road” industries.

One hundred years ago, most economists held a mix of neoclassical and institutionalist views. But as the 20th century wore on, the two theories diverged, both for methodological reasons—neoclassical tools became increasingly mathematical, whereas institutionalists relied on case studies—and ideological ones—institutionalists supported unionization and regulation of the labor market, whereas neoclassicals increasingly shunned these policies. The 1930s through the 1950s saw the zenith of institutionalist influence, both in the field of labor economics and in the corridors of power. Institutional arguments (along with powerful political considerations) underpinned Depression-era laws such as the Fair Labor Standards Act and the Wagner Act, as well as wartime regulation of industrial relations.

In the 1960s, neoclassical labor market analysis gained the upper hand. Elegant mathematical formulations developed by economists attracted scholars, as did the large data sets newly available for analysis with emerging computer technology. The sharp class struggles of the 1930s that had fueled institutionalist fortunes receded from the collective memory. Despite the flowering of segmentation theories in the 1960s and 1970s, the reigning analyses of labor markets and poverty remained neoclassically grounded (O’Connor 2001).

Beginning in the 1980s, neoclassical dominance took yet another turn (Neal and Rosen 2000). Encouraged by economist Gary Becker’s application of neoclassical analysis to such “non-economic” topics as marriage and child-bearing, orthodox economists used their tools to model labor market institutions. Interestingly, the conclusions and even policy recommendations of this “new information economics” sometimes replicate those of the institutionalists. For instance, Jeremy Bulow and Lawrence Summers (1986) used neoclassical incentive analysis to model a segmented labor market, and concluded that policies subsidizing the primary sector would

increase efficiency. Nonetheless, this and other neoclassical models are driven by efficiency considerations and the pursuit of self-interest by rational individuals. Like older neoclassical models, they leave little space for acknowledging the influence of power, history, or culture.

Why are some people more likely to end up unemployed or in low-wage jobs?

Wage levels and unemployment rates differ markedly by gender, race, and ethnicity (Table 2). As is well known, men in the United States earn higher average wages than women, whites and Asians earn more than blacks and Latinos, and Latinos and especially blacks suffer from higher unemployment. Relative poverty rates track these regularities in earnings (U.S. Census Bureau 2000).

Neoclassical theories explain who gets what job in much the same way that they explain pay differences across jobs—via differences in skills and therefore in potential productive capacities. Human capital theorists (Becker 1964) extended the basic productivity theory by reasoning that (1) a person would only defer earnings to obtain more education if the added learning increased his or her potential wage; and (2) an employer would pay a higher wage to more educated workers only if they were indeed more productive (on average). Human capital theory has been applied, not just to education, but to a variety of parental and self investments yielding higher productive returns, ranging from health care to reading bedtime stories. Others have pointed to—and argued about—the role of inherited abilities and the growing importance of “soft skills” such as motivation and style of interaction (Bowles, Gintis, and Osborne 2001, Moss and Tilly 2001). In general, orthodox economists have attributed most of racial and ethnic differences in wages and unemployment to skill disparities, and policy advocates have used this analysis to bolster calls for better education for African Americans and Latinos. This explanation does not

serve well for gender differences, since women now attain education on average slightly higher than men (and presumably inherit abilities similar to those of their brothers); more on this below.

At a polar opposite to hiring theories based on merit are those based on discrimination, espoused by critical theorists including radicals, institutionalists, and feminists. Social scientists appeal to a variety of mechanisms to explain discrimination, including subconscious psychological attraction to those who are similar, conscious solidarity and defense of privilege, and employer-fomented divisions among workers (Reich). Critical theorists use discrimination to explain occupational segregation, such as that between men and women. To the extent that women or other groups are “crowded” into a restricted set of jobs, excess labor supply will drive down the wages offered to them. In addition, sociologist Paula England and colleagues (1994) documented that a higher proportion of women in an occupational category is associated with lower average wages, suggesting that the mix of job-holders itself affects the valuation of the job.

The diagnosis of discrimination has led to three main policy prescriptions. First, and most straightforward, are laws—some dating as far back as the ratification of the Fourteenth Amendment to the Constitution in 1868—barring discrimination in hiring and wage-setting, and mandating affirmative action to offset the effects of past discrimination. Second, beginning in the 1970s, feminists have observed that “equal pay for equal work” helps women little if they are located in different jobs than men, and consequently have argued for pay equity—laws requiring equal pay to jobs of “comparable worth” as determined by a comparison of job characteristics (England 1992). Third, leaders of communities of color have called for community development to expand employment opportunities within those communities (Ferguson and Dickens 1999).

Neoclassical theorists have grappled with the concept of discrimination as well. As Becker (1957) pointed out, if employers indulge a “taste for discrimination,” they are foregoing hiring the

most productive workers, and/or paying more than they must to obtain equally productive workers. This suggests that market competition will erode discrimination. Similarly, neoclassical theory is inclined toward the view that occupational segregation results from differing worker tastes or aptitudes rather than discrimination. However, theorists of *statistical discrimination* observed that it may be narrowly efficient—but not socially desirable—for employers to discriminate based on information about group averages or variances (e.g., “women do not stay at jobs as long on average,” “African Americans on average have less skill”) (Arrow 1973).

While skill and discrimination have loomed largest in theories of hiring, sociologists (and some economists) also highlight a variety of other exclusionary social structures. The *spatial mismatch theory* holds that residential segregation has cut many blacks off from the jobs most appropriate to their skill levels, especially given increased suburbanization of manufacturing and retail jobs (Ihlanfeldt 1999). Noting that a large proportion of jobs are found through personal connections, some have argued that less effective social networks disadvantage the poor (Montgomery 1991). Feminists, assessing the high poverty rates of single mothers, have suggested that an important part of the problem is lack of hours flexibility in higher-paying jobs and, more generally, workplace demands that are biased toward the “male breadwinner” household ideal. (Albelda and Tilly 1997). Sociologist William Julius Wilson (1995) and others, echoing Myrdal’s (1944) notion of cumulative causation, have hypothesized that concentrated poverty unleashes a self-reinforcing cycle of social isolation, decreased orientation to work, and insufficient investment in skills. In its “culture of poverty” variant, this view converges with neoclassical concerns about skills, aptitudes, and work ethic (Mead 1992).

The academic and political fortunes of analyses linking poverty to labor market discrimination have largely followed those of the Civil Rights movement. Theories of

discrimination saw an upturn of interest after World War II, and then flourished during the 1960s and 1970s. Although theorizing and policy-making in this vein have continued, their influence has waned since the 1980s in the face of political and theoretical backlash and the claim that the Civil Rights Act of 1964 greatly diminished the extent of discrimination. Currently, most research and public policy attention focuses on skills.

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See also Capitalism; Economic Theories; Employment Policy; Income Inequality; Unemployment

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