

PREFACE TO THE SECOND EDITION

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The original motivation for writing *Labor Economics* grew out from my years of teaching labor economics to undergraduates. After trying out many of the textbooks in the market, it seemed to me that students were not being exposed to what the essence of labor economics was about, to try to *understand* how labor markets work. As a result, I felt that students did not really grasp *why* some persons choose to work, while other persons withdraw from the labor market; *why* some firms expand their employment at the same time that other firms are laying off workers; or *why* earnings are distributed unequally in most societies.

The key difference between *Labor Economics* and other textbooks lies in its philosophy. I believe that knowing the *story* of how labor markets work is, in the end, more important than showing off our skills at constructing elegant models of the labor market or remembering hundreds of statistics and institutional details summarizing labor market conditions at a particular point in time.

I doubt that many students will (or should) remember the mechanics of deriving a labor supply curve or the way that the unemployment rate is officially calculated ten or twenty years after they leave college. However, if students could remember the *story* of the way the labor market works—and, in particular, that workers and firms respond to changing incentives by shifting the amount of labor they supply or demand—the students would be much better prepared to make informed opinions about the many proposed government policies that can have a dramatic impact on labor market opportunities, such as a “workfare” program requiring that welfare recipients work, or a payroll tax assessed on employers to fund a national health care program. The exposition in this book, therefore, stresses the *ideas* that labor economists use to understand how the labor market works.

Although the book makes extensive use of labor market statistics and reports evidence obtained from hundreds of research studies, the data and empirical findings are not the heart of the book. These data summarize the stylized facts that a good theory of the labor market should be able to explain, as well as help shape our thinking about the way the labor market works. The main objective of the book, therefore, is to survey the field of labor economics with an emphasis on *both* theory and facts. As a result, the book relies much more heavily on “the economic way of thinking” than existing textbooks. I believe this approach gives a much better understanding of labor economics than an approach that minimizes the story-telling aspects of economic theory.

Requirements

The book uses economic analysis throughout the discussion. *All* of the theoretical tools are introduced and explained within the textbook. As a result, the only prerequisite is that the student has some familiarity with the basics of microeconomics, particularly supply and demand curves. The exposure acquired in the typical introductory economics class more than satisfies this prerequisite. All other concepts (such as indifference curves, budget lines, production functions, and isoquants) are motivated, defined, and explained as they appear in our story. The book does not make use of any mathematical skills beyond those taught in high school algebra (particularly, the notion of a slope).

Labor economists also make extensive use of econometric analysis in their research. Although the discussion in this book does not require any prior exposure to econometrics, the student will get a much better “feel” for the research findings if they know a little about how labor economists manipulate data to reach their conclusions. The appendix to Chapter 1 provides a simple (and very brief) introduction to econometrics, and allows the student to visualize how labor economists conclude, for instance, that wealth reduces labor supply, or that schooling increases earnings.

Changes in the Second Edition

The Second Edition incorporates three major changes. First, the exposition of many of the theoretical models has been greatly simplified. Users of the previous edition will find that the models have been condensed to their bare essentials, minimizing the need for introducing additional jargon or concepts, and yet maintaining the essence of what the models teach us about the way the labor market works. This simplification should considerably broaden the appeal of the book. The Second Edition also contains a larger repertoire of policy-relevant applications. There are now a sufficiently large number of applications that users may be able to “pick and choose,” depending on the nature of the course that is being taught. The addition of these examples, I believe, has changed the feel of the book, away from a theoretical emphasis to one that is much more applications-oriented. Finally, the book includes a brand new chapter on “The Wage Structure.” This chapter summarizes the recent (and large) empirical literature that attempts to understand why the wage distribution changed so much in the past decade in many industrialized countries, particularly in the United States.

Among the specific changes included in the Second Edition are:

1. An analysis of how the Earned Income Tax Credit affects the labor supply decisions of affected families.
2. Numerous examples of the empirical methodology of “difference-in-differences.” This easy-to-understand procedure gives students a much better grasp of the advantages and limits of state-of-the-art empirical research in labor economics.
3. A discussion of how taxes and subsidies affect labor demand.
4. An analysis of the link between affirmative action programs and the firm’s costs of production.
5. The chapter on human capital now contains a unified treatment of both school and post-school investments.
6. A discussion of the intergenerational correlation in earnings, and of the concept of regression towards the mean.
7. A discussion of the increased job instability that occurred in the U.S. labor market in the 1980s, and how this instability differs across skill groups.
8. A discussion of the occupational crowding hypothesis.
9. A discussion of the theory of implicit contracts and its link to structural unemployment.
10. An analysis of the link between efficiency wages and the “wage curve,” the empirical relation between wages and unemployment.

Organization of the Book

The instructor will find that this book is much shorter than other labor economics textbooks. The book contains an introductory chapter, plus 12 substantive chapters. If the instructor wished to cover all of the material, each chapter could serve as the basis for about a week's worth of lectures in a typical undergraduate semester course. Despite the book's brevity, the instructor will find that all of the key topics in labor economics are covered. The discussion, however, is kept to essentials as I have tried quite hard not to deviate into tangential material, or into ten-page-long ruminations on my pet topics. The book, therefore, is geared towards those who prefer their labor economics "short and sweet."

Chapter 1 presents a brief introduction that exposes the student to the concepts of labor supply, labor demand, and equilibrium. The chapter uses the "real-world" example of the Alaskan labor market during the construction of the oil pipeline to introduce these concepts. In addition, the chapter shows how labor economists contrast the theory with the evidence, as well as discusses the limits of the insights provided by both the theory and the data.

The book begins the detailed analysis of the labor market with a tour of labor supply. Chapter 2 presents the static theory of labor supply (how workers allocate their time at a point in time), while Chapter 3 extends the basic model in a number of directions, including the analysis of how workers allocate their time over time as well as a discussion of household production. The book then turns to a discussion of labor demand in Chapter 4. Chapter 5 puts together the supply decisions of workers with the demand decisions of employers and shows how the market "balances out" the conflicting interests of the two parties.

The remainder of the book extends and generalizes the basic supply-demand framework. Chapter 6 stresses that jobs differ in their characteristics, so that jobs with unpleasant working conditions may have to offer higher wages in order to attract workers. Chapter 7 stresses that workers are different, either because they differ in their educational attainment or in the amount of on-the-job training they acquire. These human capital investment help determine the economy's wage distribution. Chapter 8 discusses how changes in the rate of return to skills in the 1980s and 1990s changed the wage distribution in many industrialized economies, particularly in the United States. Chapter 9 describes a key mechanism that allows the labor market to balance out the interests of workers and firms, namely labor turnover and migration.

The final section of the book discusses a number of distortions and imperfections in labor markets. Chapter 10 analyzes how labor market discrimination affects the earnings and employment opportunities of minority workers and women. Chapter 11 discusses how labor unions affect the relationship between the firm and the worker. Chapter 12 notes that employers often find it difficult to monitor the activities of their workers, so that the workers will often want to "shirk" on the job. The chapter discusses how different types of labor market contracts arise to discourage workers from misbehaving. Finally, Chapter 13 discusses how unemployment can arise and persist in labor markets.

The text uses a number of pedagogical devices designed to deepen the student's understanding of labor economics. A chapter typically begins by presenting a number of stylized facts about the labor market, such as wage differentials between blacks and whites or between men and women. The chapter then presents the story that labor economists have developed to understand why these facts are observed in the labor market. The chapter then extends and applies the theory to other labor market phenomena. Each chapter typically contains at least one lengthy application of the material to a major policy issue, as well as a number of boxed examples showing the "Theory at Work."

The end-of-chapter material also contains a number of “student-friendly” devices. There is a chapter summary describing briefly the main lessons of the chapter; a “Key Concepts” section listing the major concepts introduced in the chapter (when a key concept makes its first appearance, it appears in **boldface**). Each chapter also includes “Summary Questions” that the student can use to review the major theoretical and empirical issues. The chapter then ends with a set of problems that test the student’s understanding of the material.

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