Regulation of Wages and Hours

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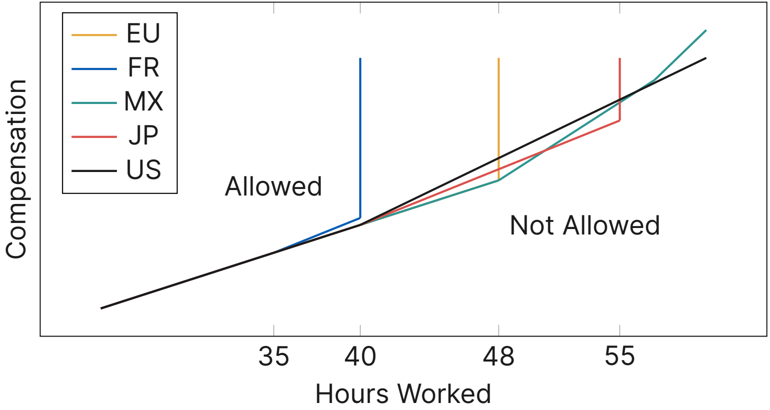
Federal Trade Commission

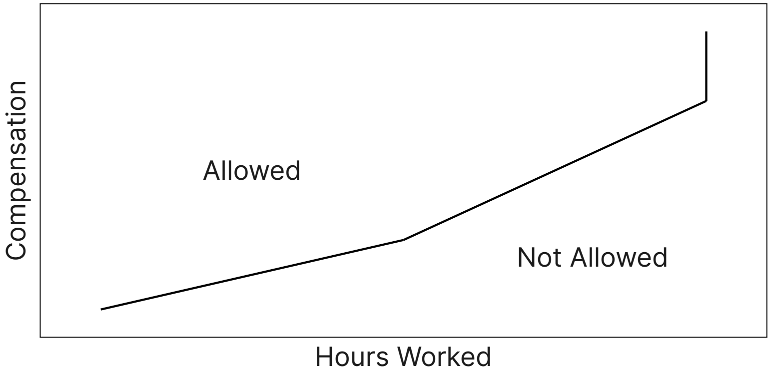
Introduction

Overtime and hours caps



Such regulations are common and heterogeneous: **Why? What is optimal?**

Optimal robust regulation resembles existing policies



Optimal policy is minimum wage, overtime, and cap on hours

Regulating wages and hours

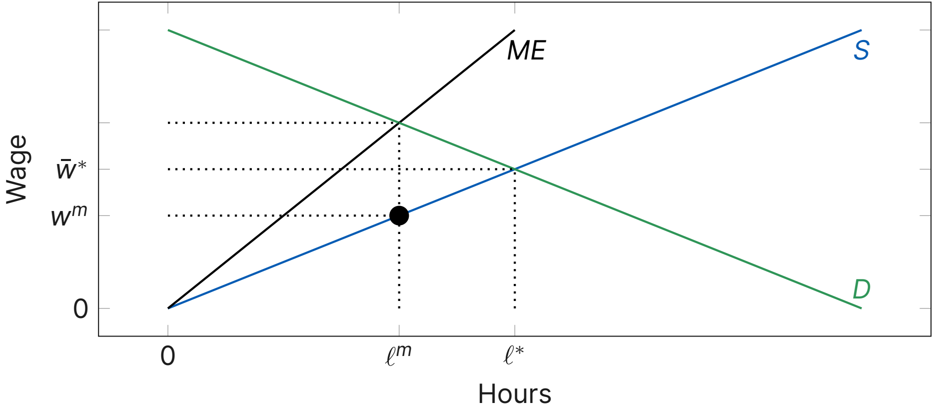
To study, need model of hours bargaining and regulation

- *Pareto efficient* joint bargaining of hours and wages
- *Redistributive* regulation that restricts bargaining space

Overtime, hours caps, and minimum wage are examples of such regulations

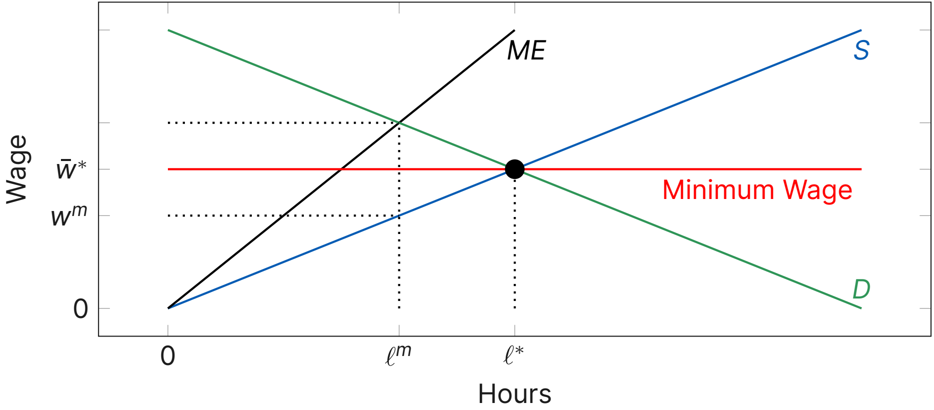
Flexible-hours model

Canonical flexible-hours model of monopsony



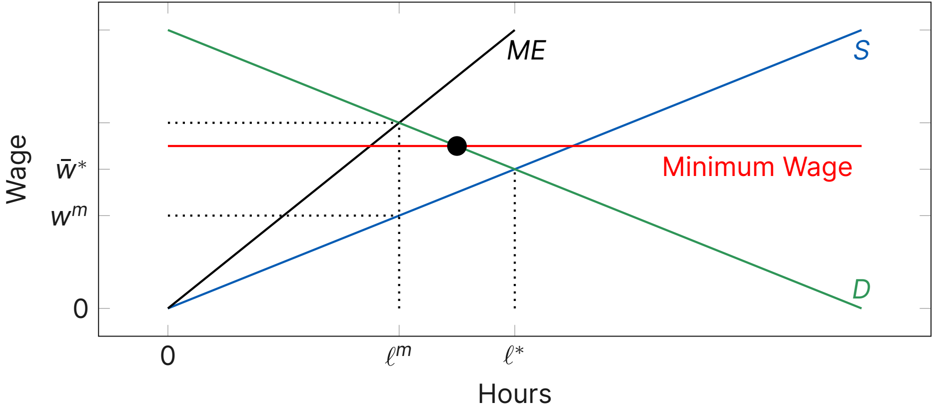
Worker chooses hours at posted wage: *hours not contractible*

Canonical flexible-hours model of monopsony



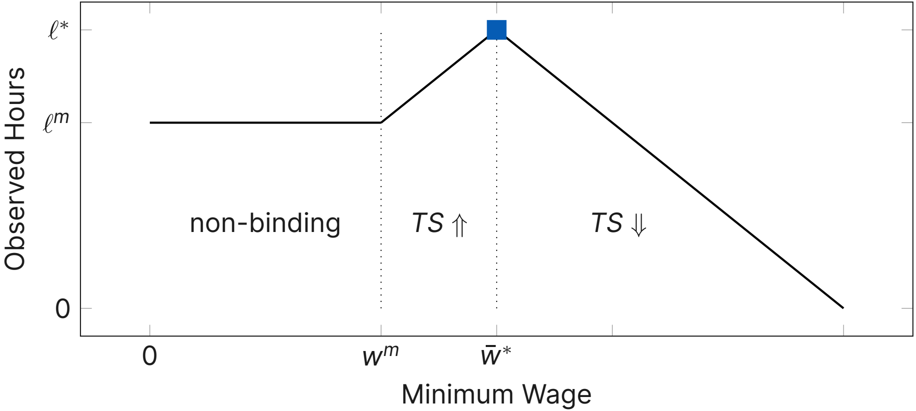
Minimum wage can increase labor to TS maximizing level

Canonical flexible-hours model of monopsony



Labor hours decrease in minimum wage after TS maximizing point

Effect of minimum wage on labor and total surplus



Increasing/maximizing hours and increasing/maximizing total surplus are equivalent

Ultimatum bargaining model

Ultimatum framework

- One firm contracts with one worker (extend later)
- Contract (ℓ, τ): worker works ℓ hours for total compensation τ
- Firm makes "take it or leave it" offer[1] under complete information
- Firm profits

$$\pi(\ell, \tau) = f(\ell) - \tau,$$

worker payoff

$$u(\ell, \tau) = \tau - c(\ell).$$

[1] In paper, allow for more general bargaining.

Ultimatum framework

- Firm makes "take it or leave it" offer[1] under complete information
- Firm profits

$$\pi(\ell, \tau) = f(\ell) - \tau,$$

worker payoff

$$u(\ell, \tau) = \tau - c(\ell).$$

Assume:
$f, -c, -c'(x)x$ strictly concave, differentiable, $f'(0) > c'(0) > 0 > \lim_{x \to \infty} f'(x) - c'(x)$

[1] In paper, allow for more general bargaining.

Wage and overwork

Definition (Wage)
Worker's wage is compensation per hour: $w \equiv \tau/\ell$

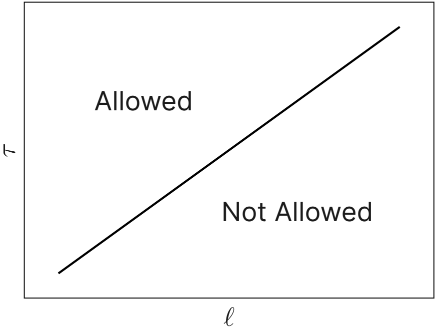
Definition (Overwork)
Worker is overworked if she would prefer to work fewer hours for the same wage:

$$\text{wage} < \text{marginal cost}$$

Regulation/delegation

Definition (Regulation)
A convex function of hours, $\phi : \mathbb{R}_+ \to [0, \infty]$, s.t. contracts in $\{(\ell, \tau) : \tau < \phi(\ell)\}$ are forbidden.

Definition (Minimum wage)
The slope of a linear policy. That is, $\bar{w}$ is the minimum wage if $\phi(x) \equiv \bar{w}x$.



Objective of regulation

Regulator's objective:
Maximize total surplus and break ties in favor of worker[2]

[2] More aggressive redistribution considered later

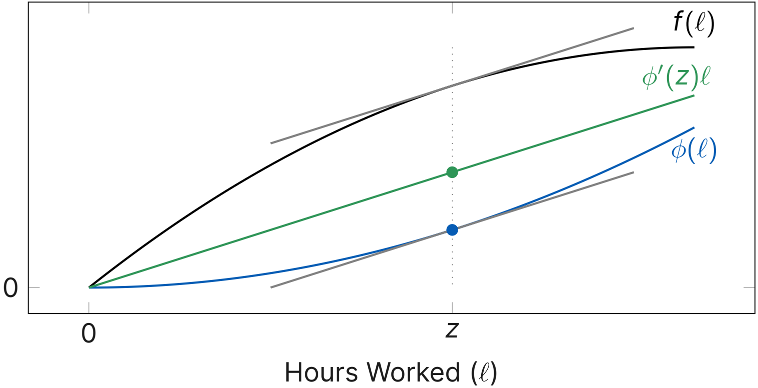
Results

Overwork

Ultimatum game without regulation:

- Firm extracts all surplus
- Total surplus is maximized
- Wage is worker's average cost
- Worker is overworked (average cost $<$ marginal cost)

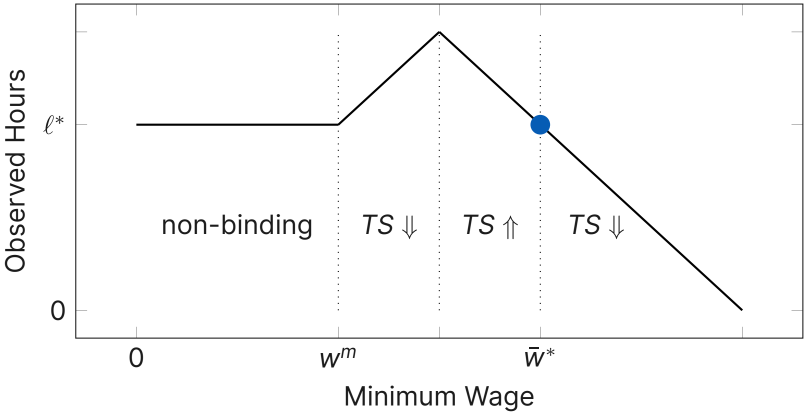
Minimum wage maximizes worker utility



Minimum wage is first best

If ϕ results in z hours, minimum wage $\phi'(z)$ results in z hours with more compensation

Effect of minimum wage on hours and total surplus in ultimatum model



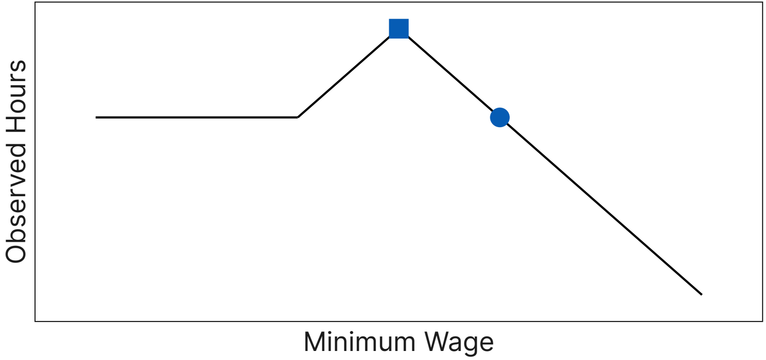
Increasing/maximizing hours and increasing/maximizing total surplus **not** equivalent

Models are “indistinguishable”

Remark
Flexible-hours model generates same labor curve as ultimatum model with same production and different cost

- Impossible to distinguish between models based on labor reaction to policy
- No result of ultimatum model hours empirically inconsistent with flexible-hours

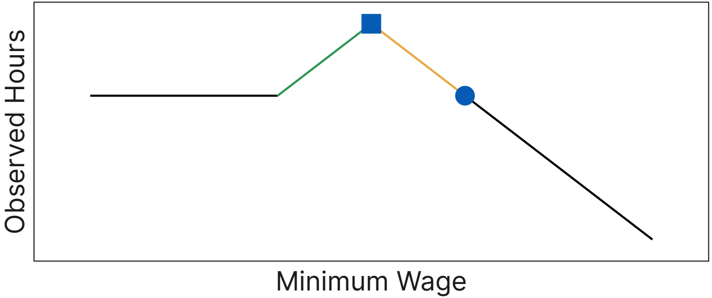
Using labor response curve to regulate



flexible-hours: ■ maximizes TS

ultimatum model: ● maximizes TS $\Longrightarrow$ ■ **is local TS minimum**

TS decreasing in minimum wage in at least one model



Remark
If total surplus increasing in minimum wage at w in one model, it's decreasing in other

Wrong model $\implies$ opposite effect of policy on total surplus!

Extensions

- Robust regulation
- More general bargaining
- Heterogeneous workers
- Competition among firms

Thank You!

Extensions

Why are many real policies nonlinear?

Back

"Best" policy for worker is minimum wage, but **information is limited**

Consider case where regulator

- knows nothing about f, c, but knows *hours* and *compensation*
- knows some specific reduced hours that the worker prefers

Historical motivation

Back

Similar to introduction of overtime pay in the US (1938 Fair Labor Standards Act)

- Regulator knows workers want 40 hour workweek
- No existing regulation

Introducing the regulator

Back

Regulator has no prior over f, c, but

- knows state of market pre-regulation: (ℓ^m, τ^m)
- knows reduced hours, $\hat{\ell} < \ell^m$, preferred by worker at same wage: $(\hat{\ell}, w^m \hat{\ell})$

Worker gets this known preferred contract or better

Regulator's objective: TS maximizing satisficing contract

Back

Offer at least as much utility to worker as known preferred contract

Satisficing
Let $\mathcal{L}[\phi]$ denote the firm's labor choice under regulation ϕ. Policy ϕ is satisficing if for all f, c such that $f'(\ell^m) = c'(\ell^m)$ and $c(\ell^m) = \tau^m$,

$$\max\{\phi(\mathcal{L}[\phi]) - c(\mathcal{L}[\phi]), 0\} \geq w^m \hat{\ell} - c(\hat{\ell})$$

Regulator's objective: TS maximizing satisficing contract

Back

Take satisficing contract that maximizes total surplus in every possible state

TS maximizing
Policy ϕ is TS maximizing if for all f, c such that $f'(\ell^m) = c'(\ell^m)$ and $c(\ell^m) = \tau^m$ and all satisficing ψ,

$$f(\mathcal{L}[\phi]) - c(\mathcal{L}[\phi]) \geq f(\mathcal{L}[\psi]) - c(\mathcal{L}[\psi])$$

This is the least restrictive one

Representation of satisficing policies

Theorem

A policy, ϕ, is satisficing if and only if $\phi(\hat{\ell}) = w^m \hat{\ell}$ and

$$\phi(x) \geq \phi_*(x) \equiv \begin{cases} w^m x & \text{if } x \leq \hat{\ell} \\ w^m \hat{\ell} + w^m \frac{\ell^m}{\ell^m - \hat{\ell}}(x - \hat{\ell}) & \text{if } \hat{\ell} < x \leq \ell^m \\ \infty & \text{if } x > \ell^m \end{cases}$$

Least restrictive satisficing regulation, ϕ_*, is TS maximizing:

- Overtime pay with wage multiplier of $\frac{\ell^m}{\ell^m - \hat{\ell}}$ and hours cap at ℓ^m

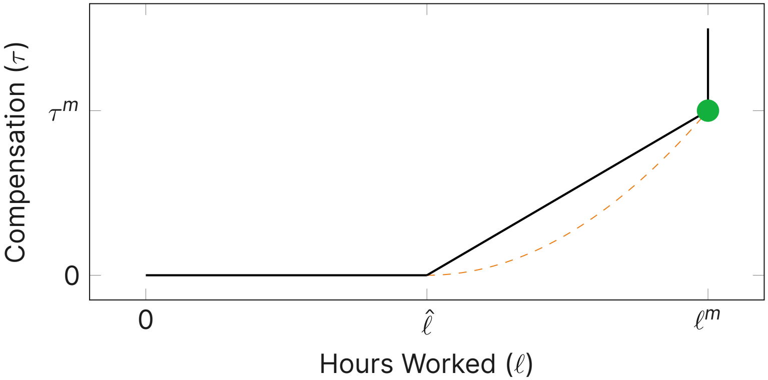
TS maximizing satisficing policy

Back

- Left of $\hat{\ell}$ is never chosen by firm
- Right of $\hat{\ell}$ is upper bound on cost of additional hours: $c(x) - c(\hat{\ell})$

Intuition behind bound on costs

Back



- Function maximizes disutility of additional hours: $c(x) - c(\hat{\ell})$
- Bound comes from convexity of c and IR of ●

Math BotE

More general bargaining

Back

Results

More Example

More general bargaining including Nash and proportional bargaining:

- Minimum wage without loss of optimality
- Efficient, redistributive regulation exists iff overwork in absence of regulation
- Maximizing hours locally minimizes TS iff overwork in absence of regulation

Softer objective needed for heterogeneous workers

Back

Consider a model where

- Multiple workers have different cost functions, c_i
- Firm contracts with workers individually
- Regulator must apply same ϕ to all workers

Efficiency is too strict with heterogeneous workers!

Need more weight on worker utility

Placing more weight on workers

Back

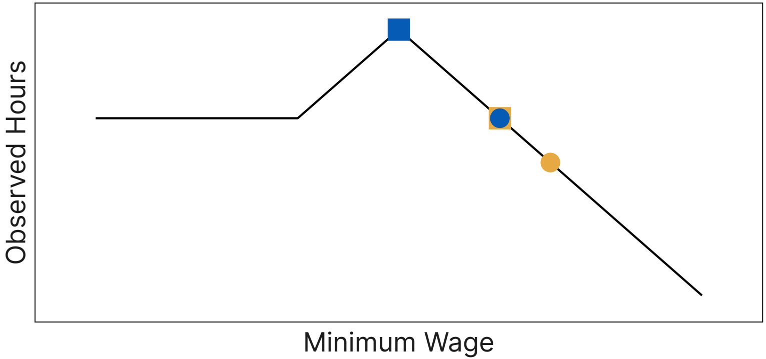
Regulator maximizes weighted sum of surpluses

Regulator objective:
Maximize $\alpha u(\ell, w\ell) + (1-\alpha)\pi(\ell, w\ell)$ for $\alpha \in (0.5, 1]$ using ϕ.

Until now, we focused on $\alpha \to 0.5$

Worker surplus maximized by larger minimum wages

Back



flexible-hours: ■ maximizes TS, ■ maximizes WS (can be above or below ●)

ultimatum model: ● maximizes TS, ● maximizes WS

Heterogeneous workers and aggregation

Back

Flexible-hours model convenient for aggregation

- Each hour treated like individual worker
- Hours are fungible across workers

Sometimes convenient to aggregate in ultimatum model too!

Complete information: heterogeneous workers

Back

Ultimatum model result
If regulator maximizes worker surplus of heterogeneous workers

- Optimal regulation is minimum wage
- Representative worker exists
- Optimal policy for representative worker is overall optimal policy
- Representative worker has average costs of all workers affected by policy

Complete information: representative worker intuition

Back

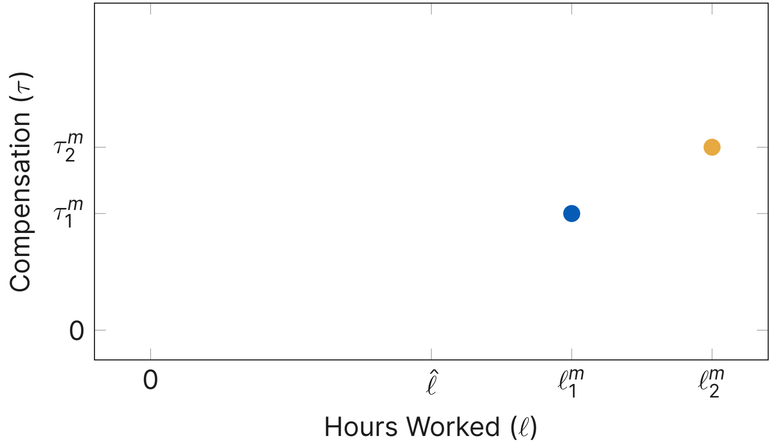
Firm's problem: $\max_{\ell,\tau} f(\ell) - \tau$ s.t. $\tau \geq \phi(\ell)$ and $\boxed{\tau \geq c_i(\ell)}$

Regulation benefits worker $\implies \tau > c_i(\ell) \implies$ contract does not depend on i

Every worker affected by regulation receives same contract!

Robust setting: heterogeneous workers

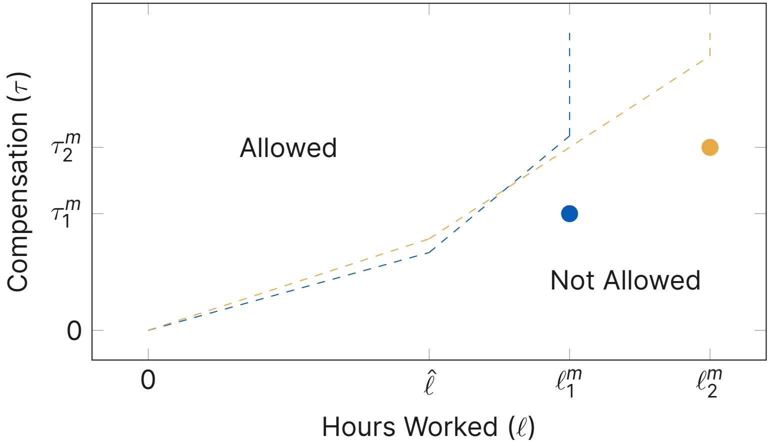
Back



Want TS maximizing satisficing contract for both Worker 1 and Worker 2

Robust setting: heterogeneous workers

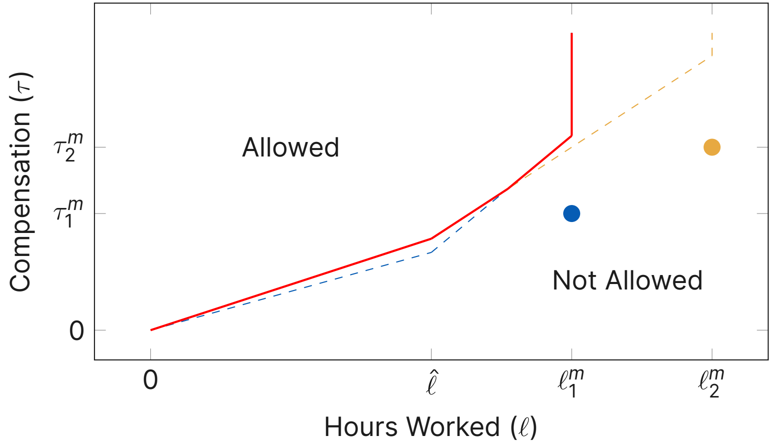
Back



Do procedure for each worker and take maximum

Robust setting: heterogeneous workers

Back



Policy may have multiple levels of overtime – e.g., California and Mexico

Asymmetric Bertrand competition with potential entrant

Back

Two firms: one incumbent and one potential entrant

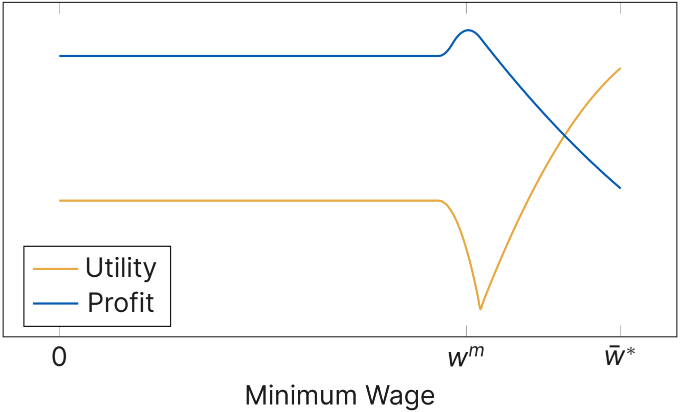
- Entrant has lower marginal productivity than incumbent
- Incumbent moves first with contract offer
- Entrant hires worker if possible to do so profitably

In equilibrium,

- Entrant offers full surplus to worker
- Incumbent matches offer of entrant's maximum surplus

Asymmetric Bertrand competition with potential entrant

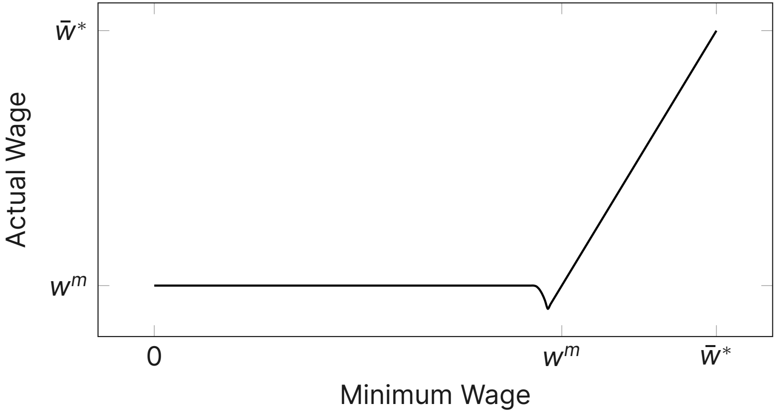
Back



Minimum wage weakens competitive pressure by regulating entrant

Asymmetric Bertrand competition with potential entrant

Back



If entrant's wage is lower, minimum wage can reduce incumbent's wage

Asymmetric Bertrand competition: policy implications

Back

Less regulation for new/small firms

- Regulate incumbent without affecting potential entrant
- Not common for pay regulation
- Common for compliance regulations:
  - Americans with Disabilities Act: 15+ employees
  - ACA Shared Responsibility Payment: 50+ employees
  - Equal Employment Opportunity reporting: 100+ employees

Thank You!

References

Peters, Hans and Peter Wakker (1991). **“Independence of Irrelevant Alternatives and Revealed Group Preferences”.** In: *Econometrica* 59, pp. 1787–1801.

Appendix

Efficient bargaining framework

Back

Bargaining according to

$$(\ell^*, \tau^*) \equiv \arg\max_{\ell,\tau} M\left(f(\ell) - \tau, \tau - c(\ell)\right) \text{ s.t. } \tau \geq \phi(\ell)$$

$M : \mathbb{R}^2_+ \to \mathbb{R}$ continuous, weakly monotone, and strictly quasiconcave

Alternatively, representation from PO, IIA, and continuity[3] (Peters and Wakker, 1991)

[3] Choice function $C : \Sigma \to \mathbb{R}^2_+$ is continuous if for every sequence, $S_k \to S \implies C(S_k) \to C(S)$

Efficient bargaining example: egalitarian bargaining

Back

Consider egalitarian bargaining

- Assume $-c$ "more concave" than f in that:

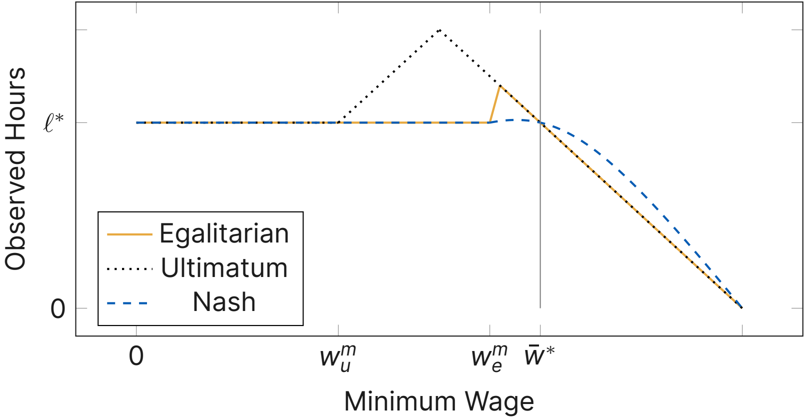
$$f(\ell^*) - f'(\ell^*)\ell^* < c'(\ell^*)\ell^* - c(\ell^*)$$

- This implies (and is necessary for) overwork
- The market is described by

$$\max_{\ell,\tau} \min\{f(\ell) - \tau, \tau - c(\ell)\} \text{ s.t. } \tau \geq \phi(\ell)$$

Egalitarian bargaining labor response

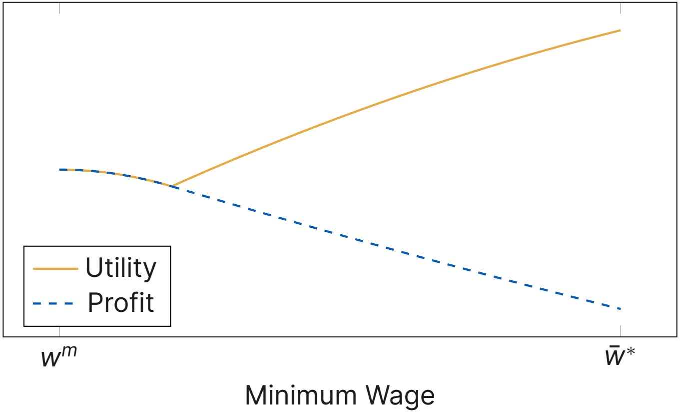
Back



Other bargaining frameworks produce similar labor response

Egalitarian bargaining payoffs

Back



Small minimum wages reduce both utility and profit

Derivation of least satisficing regulation

Back

By convexity, for all $x \in (\hat{\ell}, \ell^m)$

$$c(x) - c(\hat{\ell}) < \frac{x - \hat{\ell}}{\ell^m - \hat{\ell}} \left[c(\ell^m) - c(\hat{\ell}) \right]$$

The worker accepted $(\ell^m, \tau^m) \implies \tau^m \geq c(\ell^m)$

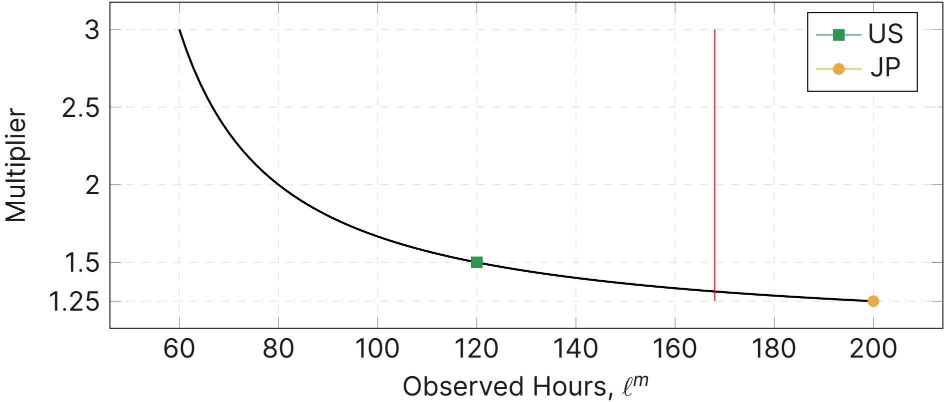
$$\frac{x - \hat{\ell}}{\ell^m - \hat{\ell}} \left[c(\ell^m) - c(\hat{\ell}) \right] \leq \frac{x - \hat{\ell}}{\ell^m - \hat{\ell}} \tau^m$$

Which we rearrange to yield

$$\frac{x - \hat{\ell}}{\ell^m - \hat{\ell}} \tau^m = w^m \frac{\ell^m}{\ell^m - \hat{\ell}} (x - \hat{\ell})$$

Existing policies are below least satisficing

Back



Satisficing policy with kink at 40 hours is above this curve
(there are 168 hours in a week)

BotE Calculation: Overtime in Japan

Back

Suppose that the overtime policy in Japan, which grants time and a quarter after 40 hours of work each week and a cap after 55 hours, is relative maxmin. In this case, $\hat{\ell} = 40$, $\bar{\ell} = 55 \leq \Psi(w^m)$ and

$$1.25 \geq \frac{\Psi(w^m)}{\Psi(w^m) - \hat{\ell}}$$

because the slope of this policy must be at least as large as the LRRM. Last inequality implies

$$\Psi(w^m) \geq 200.$$

We can reject that this policy is satisficing because there are only 168 hours in a week. Therefore, there are possible types of workers that prefer a strict 40 hour cap to this policy.

BotE Calculation: Overtime in the US

Back

Suppose that the overtime policy in the US, which grants time and a half after 40 hours of work, is relative maxmin (ignoring the lack of labor cap). In this case, $\hat{\ell} = 40$ and

$$\frac{\Psi(w^m)}{\Psi(w^m) - \hat{\ell}} \leq 1.5$$

which implies

$$\Psi(w^m) \geq 120.$$

The lack of an hour cap at such a number of hours is irrelevant. This leaves a little under 7 hours for sleep each day. Some workers do work 120 hours on occasion. It is, however, extremely rare.