Economics 314 Spring 2019
Daily Problem #41 April 25

Consider the following stylized version of the "insider-outsider" model of labor markets. Each time a shock occurs in the economy, firms negotiate with an economy-wide union to set the real wage and the level of employment. Firms offer the union a menu of choices given by the labor-demand curve; the union chooses its preferred point on that curve.

Suppose that the labor-demand curve shifts alternately between "high" and "low" as reflected by the two curves in the diagram below. The economy begins in a period of high labor demand at point *a* with full employment.

1. When the economy shifts to low demand, will the majority of union members (and their leaders) prefer to maintain wages and accept layoffs (point *b*) or a reduction in everyone's wages and a minimal reduction in employment (point *c*)? Why?

2. If unions chose point *b* during the recession, then when labor demand recovers will union members (not including those who are now outsiders because they are no longer working) opt for raising wages (*d*) or increasing employment (back to *a*)? Why?