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A welfare economic analysis of labor market policies in the Harris–Todaro model

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Abstract

This paper presents a welfare economic analysis of the benefits of various labor market policies in the Harris–Todaro labor market model. The policies considered are a policy of modern sector job creation, which I call modern sector enlargement (MSENL); a policy of rural development, which I call traditional sector enrichment (TSENR); and a policy of wage limitation in the urban economy, which I call modern sector wage restraint (MSWR). First, I analyze the inequality effects of these policies. I then perform two welfare economic analyses, the first based on summary measures of labor market conditions (total labor earnings, unemployment, inequality of labor incomes, and poverty rates) and the second based on dominance analysis in the labor market, in both cases assuming that the costs are borne elsewhere. The results of the welfare analyses are compared, and it is shown that TSENR unambiguously increases welfare in the labor market using both approaches, the other policies yield ambiguous results, and no policy is unambiguously welfare-decreasing.

JEL classification: D3; D6; J0; O2
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1. Introduction

Since its introduction in 1970, the Harris–Todaro (HT) model has become the workhorse for analyzing labor market policies in dualistic labor markets. In the intervening

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years, many aspects of the model have been studied including unemployment, development policies, tax and transfer policies, and many others; see Todaro and Smith (2003) for a review. However, one aspect of the model has not yet received thorough attention, and that is the welfare economics of labor market policies in an HT economy. The purpose of this study is to help fill that gap.

The paper proceeds as follows. In Section 2, I present the original Harris–Todaro model and review prior analyses of the effects of various labor market policies in that model. Three labor market policies were considered by Harris and Todaro themselves. The first was a policy of modern sector job creation, which I call modern sector enlargement (MSENL). MSENL could come about by a tripartite agreement, as in Harris and Todaro; by a government-sponsored employment creation scheme, as many countries have done; or by technical change and/or capital accumulation in the modern sector, which can (but need not) shift the demand curve for modern sector labor outward. The second policy considered by Harris and Todaro was rural development; focusing on the labor market effects of such a policy, I label it traditional sector enrichment (TSENR). A third policy considered by Harris and Todaro was a policy of wage limitation in the urban economy; I call this modern sector wage restraint (MSWR).[1] The review of past literature in Section 2 demonstrates that prior work has provided valuable lessons but is not yet complete in analyzing the benefits of the various policies.

The rest of the paper develops new results. Section 3 completes the inequality analysis. Section 4 then performs a welfare economic analysis of labor market conditions based on an "abbreviated social welfare function" ("abbreviated," because they are functions of variables which themselves are summary statistics of different aspects of the labor market).[2] The labor market indicators used in the abbreviated social welfare function here are total labor earnings, unemployment, inequality of labor incomes, and poverty rates. Section 5 turns to dominance analysis in the labor market (Hadar and Russell, 1969; Saposnik, 1981; Foster and Sen, 1997). Section 6 compares the welfare economic results for labor market changes using the different approaches. The main conclusions are highlighted in Section 7.

Before proceeding, let me add a word about what the results of this paper imply and do not imply about policy. If a government is choosing between MSENL, TSENR, and MSWR policies, it needs to consider not only the consequences of putting the policy into effect, which is what is analyzed here, but also the costs of putting the policy into effect. MSENL and TSENR both require expenditures of resources to create more modern sector jobs or to achieve rural development, respectively (unless, that is, an outside donor provides the money as an outright grant to the country). On the other hand, MSWR is costless (economically if not politically); actually, it saves the government money if the government is itself a modern sector employer. The social costs of these policies need to be taken account of along with the social benefits before a policy recommendation can be offered.

[1] Harris and Todaro also considered a "limited" wage subsidy, which they analyzed at length, and migration restriction, which they rejected on ethical grounds.

[2] The terminology is due to Lambert (1993).