

## [The Macroeconomic Dynamics of Labor Market Policies](#)

CFM-DP2025-10

Erik Hurst<sup>4</sup>, Patrick Kehoe<sup>1,3</sup>, Elena Pastorino<sup>2,3</sup> and Thomas Winberry<sup>5</sup>

<sup>1</sup>Federal Reserve Bank of Minneapolis, <sup>2</sup>Hoover Institution, <sup>3</sup>Stanford University, <sup>4</sup>University of Chicago Booth School of Business, <sup>5</sup>Wharton School

Two different sources of variation in wages and employment suggest that the elasticity of substitution across workers tends to be lower in the short run than in the long run. First, increases in the minimum wage alter the relative wages of affected workers. In the short run, these wage changes tend to produce small changes in employment, which suggests that the short-run elasticity of substitution across workers is low. Second, changes in demographic structure or immigration flows alter the labor supply of some groups of workers relative to others. In the long run, these changes in the relative employment of different groups of workers tend to lead to small changes in their relative wages, which implies that the response of wages in the long run to large changes in employment is small, suggesting that the long-run elasticity of substitution across different groups of workers is large.

We develop a dynamic macroeconomic framework with worker heterogeneity, putty-clay adjustment frictions, and firm monopsony power to study the distributional impact of labor market policies over time. Our framework reconciles this tension between low short-run and high long-run elasticities of substitution across inputs of production, especially among workers with different skills within the same education group. We use this framework to evaluate the effects of redistributive policies such as the minimum wage and the Earned Income Tax Credit. We argue that since these policies generate slow transition dynamics that can differ greatly in the short and long run, a serious assessment of their overall impact must take account of the entire time path of the responses they induce.