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The Proposed Immigration Reform in the United States: Its Impact on the Employment of Illegal Aliens by the Firm

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Discussion Paper Series

THE PROPOSED IMMIGRATION REFORM IN
THE UNITED STATES:
ITS IMPACT ON THE EMPLOYMENT OF
ILLEGAL ALIENS BY THE FIRM

by

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Abstract

In view of proposed immigration reform pertaining to the employment of illegal aliens we model a competitive, risk-averse firm employing legal as well as illegal workers whose wage is effectively a random variable. Inter alia we find that this wage does not affect the scale of the firm's operations; that parametric changes in the wage function of illegal workers have the expected effect on their employment yet do not affect the firm's output level; that a higher output price will result in proportionately more illegal hiring than legal hiring; and that a higher wage for legal workers may result in more of them being employed.

The intensity of the recent debate over U.S. immigration reform is subject to the same variability characterizing the fashionable length of skirts. However, as expected, much of the public debate has been passionate whereas cool headedness would have better served the important issues at stake; control over immigration cannot be addressed as if it were an issue of fashion. The Simpson-Mazzoli (SM) bill has clearly been the focal point of the debate. Although in September 1984 it died in a House-Senate Conference Committee, the commitment to bring it back to life is strong. In his October 21 Kansas City debate with Walter Mondale, President Reagan stated: "I'm going to do everything that I can, and all of us in the Administration are, to join in again when Congress is back at it, to get an immigration bill." The painstaking background work for the SM bill can be appreciated by browsing through "Immigration Reform and Control" - Report of the Committee on the Judiciary United States Senate on S.529, April 21, 1983 (S.529). The terms of reference for this major legislative effort are stated very succinctly in the opening sentence of the report: "... to increase control over both illegal and legal immigration." In order to achieve this goal, the Senate Committee and subsequently the SM bill call for employer sanctions. As put to the Conference Committee the bill would have made it illegal to hire an illegal alien. Penalties for employers who knowingly hire illegal aliens would have ranged

from \$1000 to \$2000 per alien.¹

There are critical links between the proposed bill and economic behaviour: How do firms employing legal workers and illegal migrant workers behave? How are their decisions influenced by the parameters defining the cost of employing illegal workers? Once optimizing, how do they respond to changes in the parameters that impinge upon their profit position? The rationale underlying the proposed employer sanctions may be found in the S.529 report. "We believe there have been generally adverse job impacts, especially on low income, low-skilled Americans, who are the most likely to face direct competition, even though we also perceive a degree of economic growth from the use of 'cheap' labor." (p. 5) Which of the two dominates? Will increased likelihood of being penalized and higher penalties associated with employing illegal migrants increase (menial and nonmenial) jobs available for equally skilled "unemployed or underemployed Americans"? (S.529, p. 6). Or, is it possible that stricter penalties will lead to the reverse outcome? Under the "belief" that "direct displacement" (perfect substitution) occurs, will the SM bill, if enacted and enforced, achieve the intended result? Could it be that once subjected to stricter

¹This would have been a civil, not a criminal penalty. "Only for a 'pattern or practice' of violation, may a misdemeanor (criminal) penalty of \$1,000, six months imprisonment, or both, be imposed. General principles of criminal law will apply. Therefore, only a person with the requisite managerial authority who has been shown beyond a reasonable doubt to have had an awareness or belief that he was hiring or continuing to employ, or for a fee recruiting or referring, illegal aliens will be subject to criminal penalties." (S.529, p. 11).

penalties a firm employing both illegal migrants and Americans will decrease output, possibly offering fewer jobs to Americans? Could the current economic recovery and upsurge in demand be associated with compositional employment effects which may counteract the impact of stricter penalties?

Somewhat surprisingly, these issues have hardly been exposed to formal inquiry, though it goes without saying that any fundamental piece of legislation pertaining to labour markets must be based upon an objective analysis of the behaviour of those employing labourers. The rest of this paper is thus devoted to an analysis of a firm employing illegal and legal workers and to a derivation of answers to the above questions and related ones. The basic model is presented in Section I, and a comparative statics analysis is carried out in Section II. A summary of our main results is offered in a brief concluding section.

I

Let there be two types of workers--legal workers denoted by x_1 and illegal workers denoted by x_2 . We assume that for each skill class, workers are technologically perfect substitutes for one another.

Let there be a competitive firm producing a single output, which fetches a price p , with the aid of a single, homogeneous input, namely, labour. This implies that the firm uses a single skill class of workers and is technologically indifferent between legal and illegal workers. The firm's output is given by q where

$$q = F(x_1 + x_2) \quad (1)$$

and $F(\cdot)$ is a production function such that $F' > 0$, $F'' < 0$. The cost of a legal worker to the firm is his wage, w_1 .

However, while w_1 is unlikely to be stochastic, the cost to the firm of the illegal workers is likely to be a random variable, once penalties for employing illegal workers are introduced. This is because the firm's cost of an illegal worker now becomes his wage plus a fine if the firm gets caught employing him. Since not all firms will be caught, the cost of illegal migrants becomes state contingent and hence random.² In addition, the fine itself is

²The variability alluded to in the introduction pertaining to the public interest and to the intensity of the public debate clearly affects budgetary allocations to enforcement agencies, their behaviour and the zeal with which they act.

likely to be random since the law stipulates a range for the fine and it is left to the judiciary to determine the actual fine for each case.

Hence, we can write that the cost of an illegal worker to the firm is

$$w_2 = a + bz \quad (2)$$

where a and b are positive shift parameters and z is a random variable such that $E(z) = 0$, $E(z^2) = 1$. Hence w_2 has a mean a and a variance b^2 .

In addition, let the firm incur certain fixed costs or a lump sum tax, C . The total cost of production is thus given by the random variable TC where

$$TC = w_1x_1 + ax_2 + bx_2z + C \quad (3)$$

Finally, let us assume that the firm is a von Neumann-Morgenstern expected utility maximizer with a utility function $U(\cdot)$ defined upon profits. Following accepted practice we assume that this firm is risk-averse and shows decreasing absolute risk aversion.

In view of the above the firm must solve

$$\begin{aligned} \text{Max } V = & EU(pF(x_1+x_2) - w_1x_1 - ax_2 - bx_2z - C) \\ & x_1, x_2 \end{aligned} \quad (4)$$

such that $x_1 \geq 0$, $x_2 \geq 0$.

The Kuhn-Tucker conditions for a maximum are therefore given by

$$\left. \begin{aligned} EU'(\cdot)(pF' - w_1) &\leq 0 & EU'(\cdot)(pF' - w_1)x_1 &= 0 \\ EU'(\cdot)(pF' - a - bz) &\leq 0 & EU'(\cdot)(pF' - a - bz)x_2 &= 0 \\ x_1 &\geq 0, & x_2 &\geq 0 \end{aligned} \right\} \quad (5)$$

Assuming that it is worthwhile to produce some output, then if $EU'(\cdot)(pF' - w_1) < 0$, the firm will employ no legal workers but will employ some illegal workers if, simultaneously, $EU'(\cdot)(pF' - a - bz) = 0$. If, alternatively, $EU'(\cdot)(pF' - a - bz) < 0$ and $EU'(\cdot)(pF' - w_1) = 0$, the firm will employ only legal workers. Here, however, we shall concentrate on the case where the equality holds in both cases, i.e., on the case of an interior solution for x_1 and x_2 .

Hence, the equilibrium conditions which we will be considering are given by

$$V_{x_1} = EU'(\cdot)(pF' - w_1) = 0 \quad (6)$$

$$V_{x_2} = EU'(\cdot)(pF' - a - bz) = 0 \quad (7)$$

Clearly, since $pF' - w_1$ is nonstochastic, equation (6) may be

rewritten as

$$pF' - w_1 = 0 \quad (6a)$$

From equation (6a) we obtain the first main result of the analysis; clearly, $x_1 + x_2$ is determined solely by the ratio of w_1 to p , since $F'(x_1 + x_2) = w_1/p$ may be inverted to yield $(x_1 + x_2) = G(w_1/p)$, where $G' < 0$. Thus total employment by the firm is affected only by the price of output and the price of legal labour. Neither the various parameters describing the cost of illegal labour, i.e., a and b , nor the firm's attitude toward risk affect the firm's output decision. As we shall see, these parameters and attitude do have an effect, but only on the ratio of x_1 to x_2 , not on the scale of operations.

Using equations (6) and (7) it is possible to plot the equilibrium conditions in the x_1 and x_2 plane. Denoting (6) by V_1 and (7) by V_2 and noting that the cross derivative $V_{x_1x_2} = pF'' EU'(\cdot) < 0$, the situation is depicted in Figure 1, where the equilibrium values of x_1 and x_2 are x_1^* and x_2^* , respectively.

Two points should be noted about this Figure. First, V_1 must be steeper than V_2 to satisfy the second order condition for a maximum $V_{x_1} V_{x_2} - (V_{x_1x_2})^2 > 0$. Second, V_1 has a slope of 45° because

$$\left. \frac{dx_2}{dx_1} \right|_{V_{x_1} = 0} = \frac{V_{11}}{V_{12}} = - \frac{EU'(\cdot) p_F''}{EU'(\cdot) p_F''} = - 1 \quad (8)$$

This second fact is of some importance because, having a slope of 45° degrees, V_1 is the total employment curve.

This then characterizes the solution to the firm's employment decision. In the next section, we carry out a comparative statics analysis.

II

We wish to find out how the variables in our model change when changes occur in the various parameters of the model. The variables are x_1 , x_2 , and hence $x_1 + x_2$. The parameters whose effect we shall investigate are p , w_1 , C , a , b .

(a) The effect of output price, p

From (6) and (7) we know that

$$V_{x_1 p} = EU'(\cdot)F' \quad (9)$$

$$V_{x_2 p} = EU'(\cdot)F' + qEU''(\cdot)(pF' - a - bz) \quad (10)$$

Clearly, $V_{x_1 p}$ is positive. Also, provided that absolute risk aversion is decreasing, $V_{x_2 p}$ can be shown to be positive (see Appendix). Therefore, when p increases, both V_1 and V_2 shift upwards. Hence, denoting the post change curves as V_1' , V_2' , two possibilities are mapped out in Figure 2.

In the first, in Figure 2(a), the increase in p changes the equilibrium from E to E_a . Thus, both x_1 and x_2 rise. The rationale for this result is straightforward: As the price of output increases, total employment expands. Also, since as a result of the price increase the firm is now "better off," it is less risk-averse and may be prepared to employ more illegal workers. The expansion in employment arising from an increase in price is thus biased

toward illegal workers, but nonetheless, in this case the firm employs both more legal and illegal workers.

In the second possibility, depicted in Figure 2(b), the firm moves from E to E_b so that x_2 and $x_1 + x_2$ increase, and x_1 decreases; in this case, the bias toward employing illegal workers is stronger, so that even though total employment $x_1 + x_2$ increases, x_2 increases by more so that x_1 must decline. In this case, therefore, the increase in the price of output will reduce the number of legal workers, though illegal employment and output will rise.

(b) The effect of the legal workers wage rate, w_1

From (6) and (7) we know that

$$V_{x_1 w_1} = -EU'(\cdot)F' < 0 \quad (11)$$

and, given decreasing absolute risk aversion, it can be shown that

$$V_{x_2 w_1} = -EU''(pF' - a - bz)x_1 < 0 \quad (12)$$

Hence, both V_1 and V_2 shift downwards.

The possible outcomes of the change in w_1 are based on different assumptions regarding the relative strength of the three effects that an increase in w_1 brings about: First, an output reduction effect due to the increase in the costs of production acting to reduce both x_1 and x_2 . Second, a substitution effect

acting to replace the now relatively expensive x_1 workers with x_2 workers. Third, an income effect reflecting the firm's increased risk aversion in response to a worsening in its situation and acting to substitute x_1 for x_2 .

The possibilities are depicted in Figure 3 where the post-change equilibria are denoted, respectively, by E_a , E_b and E_c . In 3(a) it is clear that neither the income effect nor the substitution effect are large, so that both x_1 and x_2 decline. 3(b) represents the case of a strong substitution effect resulting in increased employment of x_2 in response to the rise in w_1 . Finally, 3(c) represents the case of a strong income effect so that, surprisingly, x_1 rises when w_1 rises! Clearly in all cases $x_1 + x_2$ declines as dictated by $x_1 + x_2 = G(w_1/p)$.

(c) The effect of fixed costs, C

From (6) and (7) and decreasing absolute risk aversion, we know that

$$V_{x_1 C} = 0 \quad (13)$$

$$V_{x_2 C} = -EU''(\cdot)(pF' - a - bz) < 0 \quad (14)$$

Hence, V_1 will not alter and V_2 will shift downwards if there occurs an increase in a lump sum tax or other fixed costs. Therefore, this will leave output unaltered but cause the firm to substitute legal for illegal workers. As such, a lump sum tax may be used to reduce

the number of illegal workers the firm employs without reducing its output or labour force.

(d) The effect of mean illegal worker costs, a

From (6) and (7) and decreasing absolute risk aversion, we know that

$$V_{x_1 a} = 0 \quad (15)$$

and that

$$V_{x_2 a} = -[EU'(\cdot) + EU''(\cdot)(pF' - a - bz)x_2] < 0 \quad (16)$$

Hence V_2 shifts downwards, but V_1 remains unaltered so that the outcome of an increase in a , which perhaps may be interpreted as an increase of the fine imposed upon the firm, is that output does not change but a substitution of legal for illegal workers occurs.

(e) The effect of the spread, b, in illegal worker costs

From (6) and (7) we know that

$$V_{x_1 b} = 0 \quad (17)$$

$$V_{x_2 b} = -EU''(\cdot)(pF' - a - bz)x_2z - EU'(\cdot)z \quad (18)$$

which can once again be shown to be negative for decreasing absolute

risk aversion (see Appendix). Hence, output does not change, but some legal workers are substituted for illegal ones.

Our results are summarized in Table 1.

TABLE 1

Effect on Increase in	x_1	x_2	$x_1 + x_2$
p	?	+	+
w_1	?	?	-
c	+	-	0
a	+	-	0
b	+	-	0

III

We shall now summarize the main results of our analysis. The wage of illegal workers does not affect the scale of the firm's operations, viz., how much to produce and how many workers to employ. Parametric changes in the wage function of illegal workers rendering it more expensive to employ them will result in a substitution of legal for illegal workers without leading to contraction of the firm's output. There will thus be a full, one-to-one, substitution. The imposition of a lump sum tax upon firms employing legal and illegal workers will result in a likewise (full) substitution of legals for illegals as in this case also output does not change. Increase in the demand for the firm's output manifested through a higher output price will increase employment of legal and illegal workers, but the expansion will not be on a one-for-one basis; proportionately more illegal workers will be hired than will legal workers. Finally, higher wages for legal workers may, but need not, necessarily result in fewer of them being employed. Under a strong income effect, the reverse may hold!

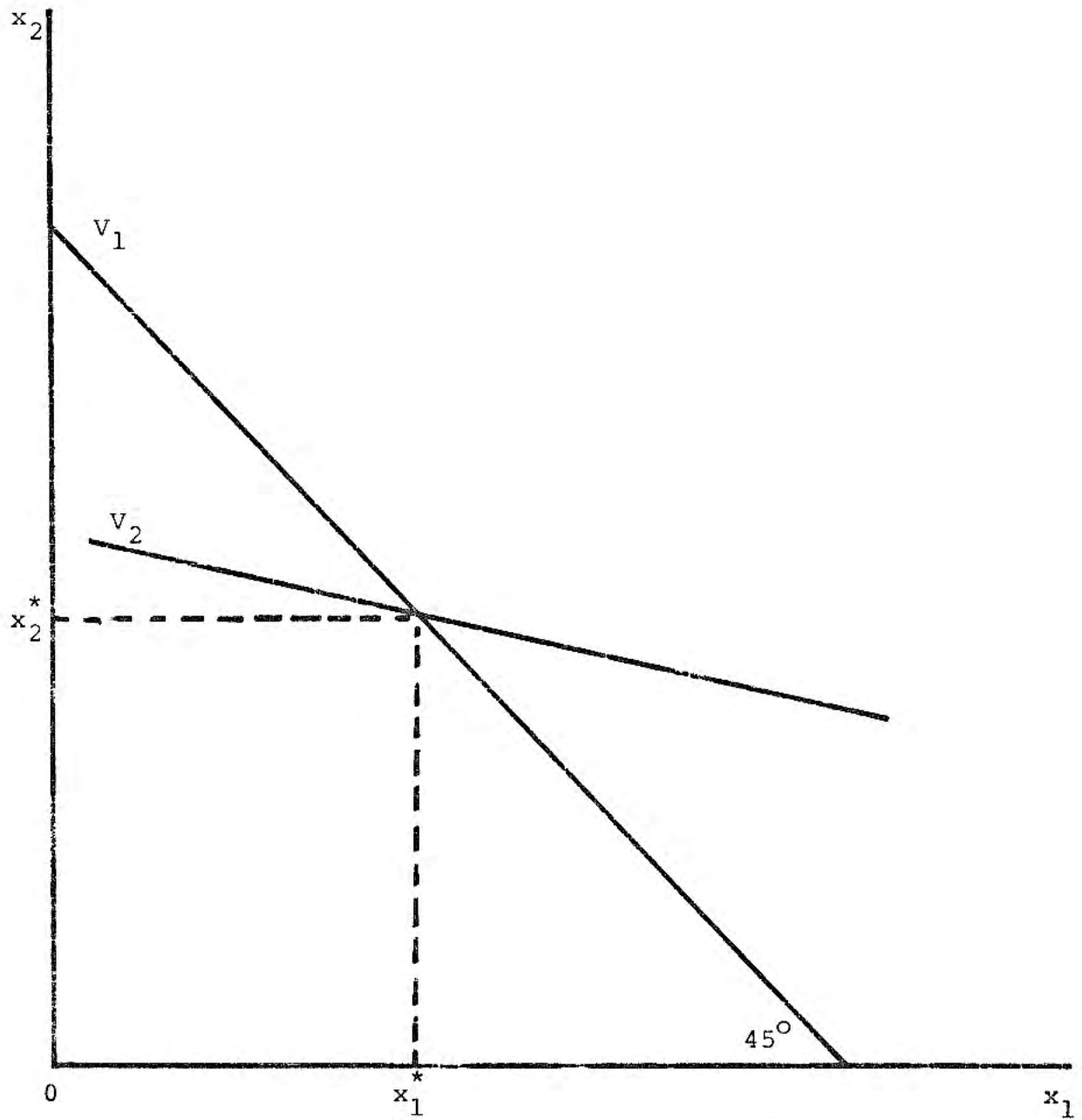
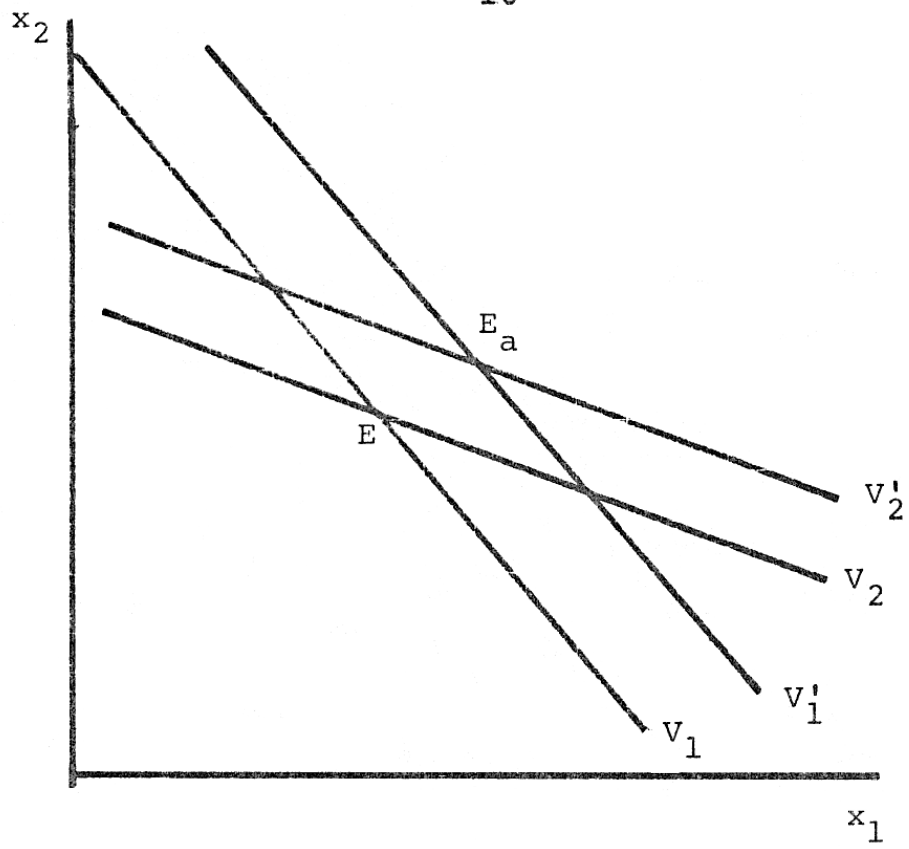
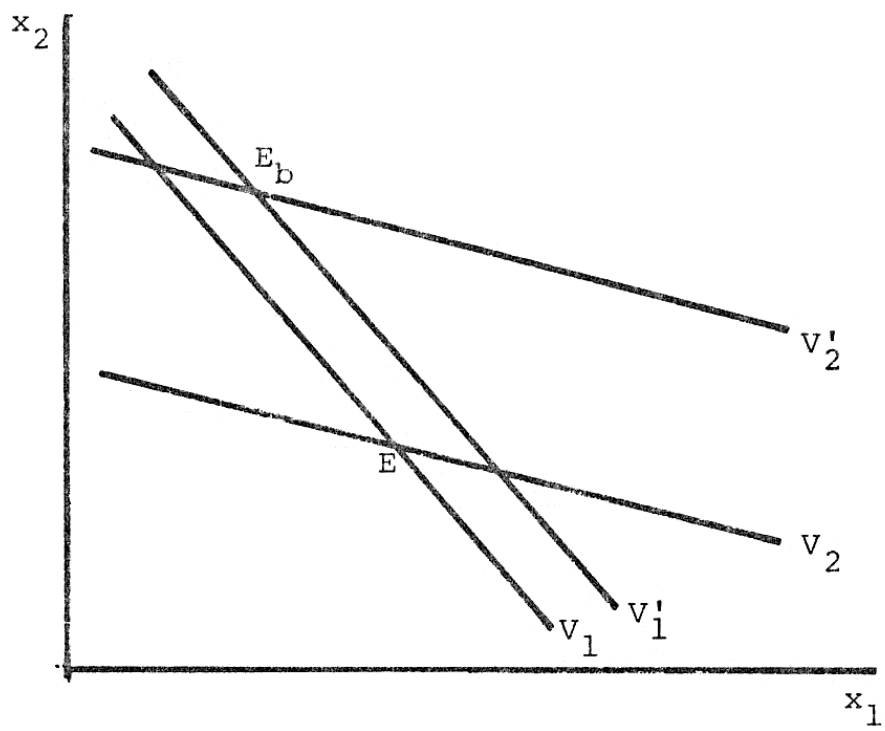


FIGURE 1



(a)



(b)

FIGURE · 2

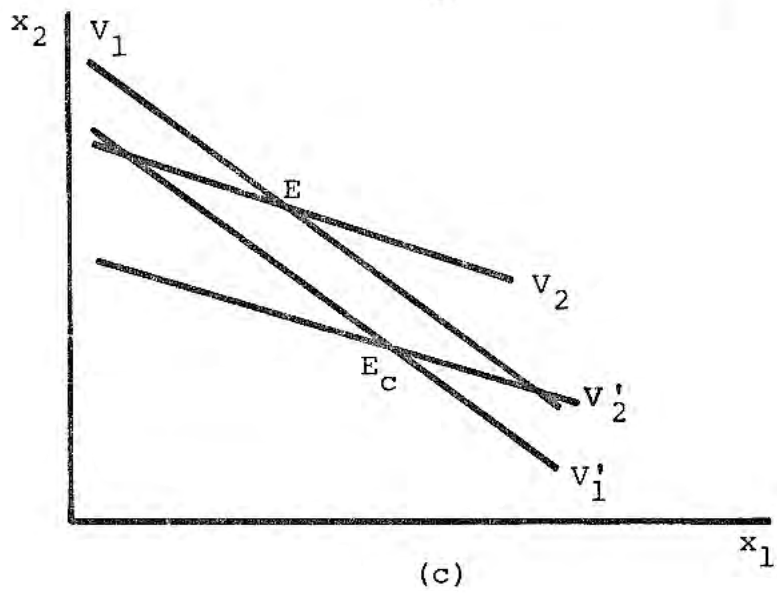
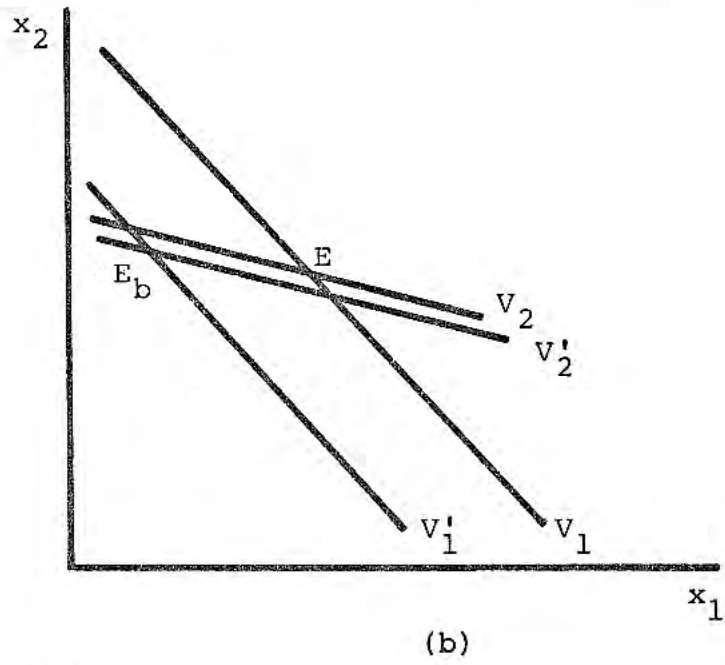
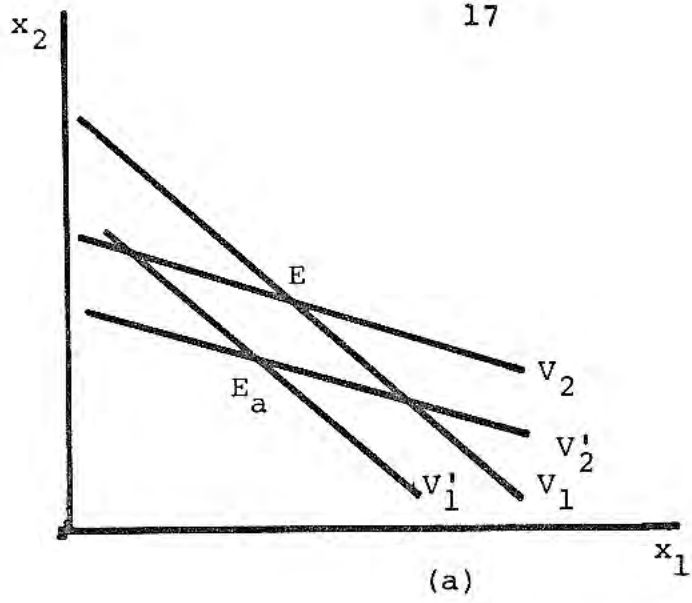


FIGURE 3

APPENDIX

$$\left. \begin{aligned} V_{x_1} &= EU'(\cdot) (pF' - w_1) = 0 \\ V_{x_2} &= EU'(\cdot) (pF' - a - bz) = 0 \end{aligned} \right\} \text{first order conditions}$$

∴

$$\begin{aligned} V_{x_1 x_1} dx_1 + V_{x_1 x_2} dx_2 + V_{x_1 p} dp + V_{x_1 w_1} dw_1 \\ + V_{x_1 c} dc + V_{x_1 a} da + V_{x_1 b} db = 0 \end{aligned}$$

$$\begin{aligned} V_{x_2 x_1} dx_1 + V_{x_2 x_2} dx_2 + V_{x_2 p} dp + V_{x_2 w_1} dw_1 \\ + V_{x_2 c} dc + V_{x_2 a} da + V_{x_2 b} db = 0 \end{aligned}$$

where, from the first order conditions,

$$\begin{aligned} V_{x_1 x_1} &= EU'(\cdot) pF'' & V_{x_1 x_2} &= EU'(\cdot) pF'' \\ V_{x_1 x_2} &= EU'(\cdot) pF'' & V_{x_2 x_2} &= EU'(\cdot) pF'' + EU''(\cdot) (pF' - a - bz)^2 \\ V_{x_1 p} &= EU'(\cdot) F' & V_{x_2 p} &= EU'(\cdot) F' + EU''(\cdot) (pF'' - a - bz)q \\ V_{x_1 w_1} &= -EU'(\cdot) & V_{x_2 w_1} &= -EU''(\cdot) (pF' - a - bz)x_1 \\ V_{x_1 c} &= 0 & V_{x_2 c} &= -EU''(\cdot) (pF' - a - bz) \\ V_{x_1 a} &= 0 & V_{x_2 a} &= -EU''(pF' - a - bz)x_2 - EU'(\cdot) \\ V_{x_1 b} &= 0 & V_{x_2 b} &= -EU'(\cdot)z - EU''(\cdot) (pF' - a - bz)x_2z \end{aligned}$$

(1) To determine the slopes of V_1 and V_2 :

$$(i) \quad V_{x_1 x_1} dx_1 + V_{x_1 x_2} dx_2 = 0$$

$$\therefore \left. \frac{dx_2}{dx_1} \right|_{V_{x_1} = 0} = - \frac{V_{x_1 x_1}}{V_{x_1 x_2}} = - \frac{EU'(\cdot) p F''}{EU'(\cdot) p F''} = -1$$

$$(ii) \quad V_{x_2 x_1} dx_1 + V_{x_2 x_2} dx_2 = 0$$

$$\therefore \left. \frac{dx_2}{dx_1} \right|_{V_{x_2} = 0} = - \frac{V_{x_1 x_2}^{(-)}}{V_{x_2 x_2}^{(-)}} < 0$$

(iii) For the second order conditions to be satisfied

$$V_{x_1 x_1} V_{x_2 x_2} - (V_{x_1 x_2})^2 > 0$$

$$V_{x_1 x_1} < 0, V_{x_2 x_2} < 0 \text{ and we know that } V_{x_1 x_2} < 0.$$

$$\therefore - \frac{V_{x_1 x_2}}{V_{x_2 x_2}} < - \frac{V_{x_1 x_1}}{V_{x_1 x_2}}$$

so that V_{x_2} is less (negatively) steep than V_{x_1} .

(2) To determine the signs of the partials:

(i) To find the sign of $EU''(\cdot) (pF' - a - bz)$ let $\bar{R}$ be absolute risk aversion at $pF' - a - bz = 0$

$\therefore$ by decreasing absolute risk aversion

$$- \frac{U''}{U'} > \bar{R} \quad \text{for} \quad pF' - a - bz < 0$$

$$- \frac{U''}{U'} < \bar{R} \quad \text{for} \quad pF' - a - bz > 0$$

$\therefore$ multiplying across by $(pF' - a - bz)U'(\cdot)$ and taking expected values yields

$$- EU''(\cdot) (pF' - a - bz) < \bar{R} EU'(\cdot) (pF' - a - bz) = 0$$

$$\therefore EU''(\cdot) (pF' - a - bz) > 0.$$

Q.E.D.

This then yields the signs of

$$V_{x_2 p} > 0, V_{x_2 w_1} < 0, V_{x_2 c} < 0, V_{x_2 a} < 0.$$

(ii) To find the sign of

$$V_{x_2 b} = - EU'(\cdot)z - EU''(\cdot) (pF' - a - bz)x_2 z$$

(A)
(B)

(A) We know that $U''(\cdot) < 0$ and hence that

$$EU'(\cdot)z = \text{covariance } (U'(\cdot), z) > 0 \text{ so that } (A) = -EU'(\cdot)z < 0.$$

(B) We know that

$$z = \frac{w_2 - a}{b}$$

which, upon adding and subtracting $\frac{F'}{b}$, yields

$$z = \frac{w_2 - F'}{b} + \frac{F' - a}{b}$$

$$\therefore (B) = + \frac{x_2}{b} EU''(\cdot) (w_2 - F')^2 - \frac{x_2}{b} EU''(\cdot) (pF' - w_2) \frac{F' - a}{b} ;$$

we know that $(F' - a) > 0$ from the first order condition. Hence $(B) < 0$.

$$\therefore V_{x_2 b} < 0.$$

Q.E.D.

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