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Editor's Introduction

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The nature of employment relationships has been a fulcrum in debates about macroeconomics since John Maynard Keynes published his *General Theory* during the 1930s. The interactions of compensation and employment with business cycles, inflation, and other sources of macroeconomic variation has been at the heart of the debate between Keynes and classical economists as well as controversies about the Phillips curve, costs of inflation, and Euroclerosis.

One reason for these decades of tumult is that the simplest supply-and-demand models of the labor market—labor services traded on an efficient spot market—fail to accord with many important features of labor markets, leading economists to believe that richer microeconomic foundations are needed to explain macroeconomic phenomena. That is as far as the consensus reaches, however, as several intellectual fault lines divide the economics profession in this area. One long-standing division lies between those who believe that modified market-clearing models provide an adequate description of labor markets and those who do not. A second, even more profound, fissure is over adherence to the narrow construction of rationality embedded in mainstream economic theory. A network of cracks always appears in connection with the evaluation of public policy toward labor markets.

The six papers and six commentaries presented at the twenty-third annual economic policy conference of the Federal Reserve Bank of St. Louis represent a diverse cross-section of perspectives on these issues from labor economists and macroeconomists. Despite the risk of

inappropriately pigeon-holing some papers, I believe it is useful to group the papers under three headings that correspond to key research agendas in the nexus between labor economics and macroeconomics.

MARKET CLEARING AND WAGE RIGIDITY

One focal point of the debate about market-clearing in labor markets has been the claim that the nominal wage paid to a specific worker with a specific job almost never falls. As an empirical matter, the proposition appears obvious to noneconomists and—superficially—it would appear to be a simple matter to evaluate the claim systematically. Attempts to do so have run into two barriers. The first is that the ideal approach is clearly to track the pay of individual workers over time, but until the advent of modern panel data sets, it was impossible to do so on a large scale. The second barrier is that the available panel data are either the records of small numbers of employers or survey responses from individuals. The former yields answers that may not generalize. The latter may be more representative, but answers are obscured by a fog of measurement error. Consequently, creative and indirect empirical strategies are needed.

One of these strategies is to examine the skewness of the distribution of *observed* wage changes in panel data. The principle is that one-sided rigidities censor the distribution of *actual* wage changes, and if the measurement error distribution is approximately symmetric, the censoring skews the distribution of *observed* wage changes to the right. Though the general strategy of examining measures of skewness is not new, Kenneth McLaughlin's article tackles the skewness question with the kind of thoroughness that occasionally shakes deeply entrenched beliefs among social scientists. McLaughlin's central point is that downward nominal rigidity implies

skewness of a specific form, but that the data display more general forms of skewness. In particular, the distribution of wage changes is skewed in the interval surrounding the median, an interval that should not be significantly related to nominal rigidity at zero. Thus, a finding of overall skewness is not particularly informative about wage rigidity; overall skewness is implied by, but does not necessarily imply, wage rigidity. In addition, McLaughlin finds that the skewness of wage changes shows little relationship to the inflation rate. Simple nominal rigidity implies that skewness would disappear when the inflation rate is high, that is, when the constraint on nominal wage changes no longer binds.

In his commentary on McLaughlin's work, Dick Startz raises the following very important question: How can we reconcile a study like McLaughlin's that persuasively challenges the idea that nominal wages are rigid with the direct experience of salary administrators for whom cutting nominal pay is simply not an option? Startz cites his own experience as department chair in this regard.

Truman Bewley's contribution to this volume grew out of an extensive study of wage rigidity along those lines—from the perspective of people involved in the wage-setting process. During the early 1990s, Bewley began to interview business people about why wages do not fall significantly during recessions. What began as a handful of informal interviews, eventually became a book based on several hundred interviews.¹ Much of Lowell Taylor's commentary is a glowing review of Bewley's book. It is difficult to summarize the results of Bewley's interviews in a few sentences, but the bottom line on wage rigidity is clear: Nearly all employers believe that lowering workers' wages would be a disastrous policy, except in extraordinary circumstances. Their stated reasons for believing this usually included the word "morale."

Economic theory, however, currently has no place for "morale." Neither, however, does it have a place for mass delusion among profit maximizers. Bewley's article

is an audacious exploration of the possibilities of a theory that takes business leaders' views seriously, giving "morale" a systematic meaning and role. Bewley starts by noting that "good morale" manifests itself in (at least) three ways: identification with the firm, good moods, and trust and affinity among individuals associated with the firm. These are fuzzy concepts, and economic theory does not have a comparative advantage in fuzziness, so the first step is to give them some precision. Bewley devotes the most attention to "mood," noting that psychologists understand that mood shapes the range of actions an individual is likely to take. In economists' language, mood systematically alters a person's preferences over actions.

Economists frequently pay lip service to the role of psychology in explaining the source of preferences and assert that economics tries to explain how individuals behave, taking preferences and constraints as given. Bewley's article takes that mantra seriously, using research in psychology to help specify preferences. Bewley posits the existence of an *unconscious* decisionmaker that regulates mood in a way that moderates *conscious* choice of actions in order to achieve unconscious objectives. Thus, Bewley's approach incorporates a dose of psychological reality, not by changing the core rationality assumptions of economics, but rather by structuring preferences in a way that leaves room for individuals to vary their behavior in different emotional circumstances.

DIGGING INTO THE COMPENSATION PROCESS

It is manifestly true that compensation does not change continuously; few, if any, people who stay in the same job experience daily changes in their salary or wage rate. Although it is clear that there is a connection between average compensation and inflation, the link does not operate continuously. But, as Erica Groshen and Mark Schweitzer point out in their paper, little is known about the actual process by which changes in the price level and other macroeconomic variables influence wages.

¹ *Why Wages Don't Fall During a Recession* will be published by Harvard University Press in 1999.

Groschen and Schweitzer have been tackling this question in a series of important papers. The article in this volume is concerned with the following question: Do wages and salaries march in lockstep with the price level, or is there cross-sectional variation in the response of different employers? In more specific terms, how is the cross-sectional distribution of wage changes related to macroeconomic variables? Using the Community Salary Survey, a unique dataset that has tracked pay for specific job classifications at specific employers for more than 40 years, they find that the influence of different macroeconomic variables varies systematically across the distribution of wage changes. (Thus, their question is broadly similar to McLaughlin's—how do macroeconomic variables affect the distribution of wage adjustments?) At the top of the distribution, where wage changes are largest, inflation is most influential. At the bottom of the wage change distribution, the unemployment rate plays a much more prominent role.

As John Haltiwanger's commentary points out, this kind of finding suggests a number of interpretations. It may, for example, be associated with rising wage inequality that has elsewhere been tied to rising relative demand for skilled workers. This ambiguity, Haltiwanger argues, emphasizes the need for subsequent development of a conceptual framework that can suggest ways in which later empirical research will be able to differentiate among potential explanations.

Wages and salaries are only the most visible and easily measured dimension of an employment relationship, but economists often use the word "wage" interchangeably with "compensation." Faced with the considerable (though not conclusive) evidence from various sources that wages and salaries rarely drop, some economists have speculated that firms' adjustments to external shocks take place on other margins, leaving intact the basic principles that underlie neoclassical models of labor markets. One line of argument is that employment or required work inten-

sity (rather than monetary compensation) absorbs the required adjustment. Alternatively, perhaps other facets of compensation (bonuses, for instance) absorb the adjustment when wages and salaries do not. Quite apart from the rather interesting, but difficult, question of why adjustments would be so strangely unbalanced, is the question of whether these other margins are used in this way. Surprisingly little is actually known about the structure of compensation across U.S. employers, so thus far the data have provided little guidance for theory.

The article by W. Bentley MacLeod and Daniel Parent is part of a larger research agenda that holds considerable promise for giving economists some of that guidance. Using information from the National Longitudinal Study of Youth and the Panel Study for Income Dynamics, MacLeod and Parent document that there is great diversity in contractual form (how compensation is packaged). They find significant connections between job characteristics (occupation and degree of autonomy, for example) and the contractual form. In particular, when explicit measurement can accurately capture on-the-job performance, the explicit measurements are more likely to be used in compensation. MacLeod and Parent emphasize that in more complex environments, where, for example, workers must balance several tasks, simple combinatorics make explicit measurement of overall performance impossible. This more or less forces employers to use subjective *ex post* performance assessments and rewards. MacLeod and Parent find empirically that pay for workers with complex jobs is more likely to be based on subjective assessments.

In his commentary James Rebitzer indicates that he is persuaded of the importance of bringing data into debates about the form of compensation, but observes that MacLeod and Parent's analysis is severely hampered by limitations of the available data sources. Rebitzer outlines the ideal dataset for studying compensation and concludes that the best social

scientists can hope for is an accretion of detailed case studies.

JOBS AS ASSETS

A recurring theme in labor economics is the value of long-term relationships between employer and employee. In the simplest supply-and-demand models, the job (that is, a match between a particular employer and a particular worker) has no value to either the employer or the worker. A job can become valuable in various ways, and the idea is central to many theories of compensation and the employment relationship. Among the most prominent sources of value are the difficulty in finding an appropriate employee or employer (search frictions), relationship-specific investments made by either party, or the intertemporal structure of compensation (the promise of higher pay in the future, for example).

One consequence of a job's value, whatever its source, and however the value is distributed between the employer and employee, is that external circumstances can change the value, even if there is no change to the employment relationship itself. One example of this principle is the role of the unemployment rate in standard efficiency-wage models. Another example would be variation in the probability of "default" in a deferred-compensation model, caused by changes in the firm's circumstances. An important question for a dynamic and stochastic model of the employment relationship is what happens when external circumstances do change. In general, this is a difficult question because it requires understanding how the distribution of future events influences the value of the match, but, generically, only three things can happen: The change in value does not alter how the relationship works; the relationship continues but with internal adjustments to, say, compensation; or the relationship ends. Confusion about this issue has led to mistaken interpretations of the theory of labor markets. Efficiency-wage models, for example, sometimes have been incorrectly portrayed as a source of real-wage rigidity.

Wouter den Haan, Garey Ramey, and Joel Watson propose a tractable theoretical framework for studying the relationship between external shocks and terms of the employment relationship. As Christopher Foote points out in his discussion, the clarity of the model is very helpful in understanding how considerations such as liquidity and verifiability mold the employment relationship. Starting with a standard moral-hazard model, they analyze how two types of contracting imperfections, limited verifiability of the employee's actions and limited liquidity, influence the outcome when the overall value of the match changes. A key result, which derives from limited verifiability, is that contracts can be fragile in the sense that a negative shock can *inefficiently* terminate the employment relationship; the relationship still has value, but there is insufficient surplus to allow internal transfers large enough to resolve the moral-hazard problem. Contractual fragility has important consequences for how the economy responds to macroeconomic shocks, which cause the value of many matches to change simultaneously. Foote's discussion elaborates on how this aspect of the paper blends into the stream of recent macroeconomic research. The authors emphasize that, "reduced form" analysis of contracting imperfections that have been prevalent in much past macroeconomic literature may hide too much of the key underlying structure."

If jobs are assets, workers will take actions to preserve or increase their value. In the political sphere, this incentive can result in labor market regulation of various sorts. These policy interventions, in turn, create labor market rigidities that many economists believe are at the root of persistently high unemployment rates throughout much of Europe, yet attempts to reform labor markets frequently fail politically.

The first objective of Gilles Saint-Paul's study of the political economy of job protection is to understand how a country can find itself in this apparently unfortunate position. He integrates two ideas, rents to existing jobs (that is, the flow of "dividends" from a valuable job) and a simple

model of the life cycle of a plant or production unit. This is an insightful modeling choice because it allows Saint-Paul to connect political choices not only to static rent-seeking, but also to the underlying dynamic structure of the economy. A worker faces tradeoffs in choosing whether to support job protection legislation. On the cost side, by making it more costly to scrap obsolete production units, the regulation lowers average living standards by increasing unemployment and by reducing job rents. On the benefit side, firing costs perpetuate the rents from a specific job. In a relatively old plant, the worker understands that the job will end relatively soon with or without firing costs, but with firing costs his next job will be harder to find and pay less. Thus a worker in this situation tends to oppose firing costs. Workers in relatively new plants see that job protection regulation will lower the rents to their jobs and may regard the prospect of job loss as sufficiently remote for job protection to be of much value. Thus, Saint-Paul's model predicts that workers in middle-aged jobs support job protection most strongly.

The bargaining power of workers, determined in part by other forms of labor legislation (the laws governing unions, for example), and the growth rate of the economy are the main factors that determine the balance among the three types of workers. The first factor implies there are political complementarities between policy reforms that reduce workers' bargaining power (limiting the power to strike, for example) and those that reduce job protection. Where an incremental approach that changes one thing at a time might fail, a package of reforms might succeed.

In his commentary, Christopher Waller raises a technical issue that is closely connected to the packaging of policy reforms. Waller observes that the structure of Saint-Paul's model generates a distribution of policy preferences across the population that is not single-peaked. A multimodal distribution can lead to voting cycles in which the preferences of the electorate over policy options are not tran-

sitive. In these circumstances, the packaging of groups of policy proposals is especially important.

I would like to close by thanking the authors and discussants for their substantial efforts—often well beyond expectation—in producing a very interesting and stimulating conference. I hope that the readers of this volume will be able to sense some of the spirit of a shared intellectual endeavor that was evident during the conference.

REVIEW

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