Sticky Stories: Economic Explanations of Employment and Wage Rigidity

By SANFORD M. JACOBY AND DANIEL J. B. MITCHELL*

There was a time when "institutional" labor economists and economic theorists literally parted company over methodology. Specifically, in the late 1940s labor economists formed their own Industrial Relations Research Association (IRRA) as a rump group of the AEA. A notable feature of the IRRA was that its membership was drawn from both academics and labor-management practitioners. The idea was that practitioners, who knew the facts of the labor market, would inform academic researchers.

Knowledge of the stylized facts of the labor market may once have been disdained by mainstream economists, especially if these observations seemed to contradict theoretical expectations. At the same time, rigorous analytical and empirical approaches were often omitted from the institutionalists' tool kit. But in recent years there has developed a "new economics of personnel" (NEP) that bases its analysis on certain potentially uncomfortable facts, yet brings to bear a high level of rigor. Some (not all!) of the older doyens of labor market institutionalism have even taken pleasure in the "new generation of exceedingly competent labor economists" (Clark Kerr, 1983, p. 21). An important question, therefore, is whether the gap between institutional knowledge and theoretical analysis has now been bridged. We are encouraged by the bridging attempt, but argue that a gap remains due in part to a tendency for the stylized facts to shift.

I. Time and Space

The NEP offers efficiency explanations for modern American employment practices such as career labor markets, wage rigidity, and seniority-based layoffs. Its reasoning is functional; the practices must be efficient or else firms pursuing alternative policies would become dominant. The explanations proffered are derived from analysis of rational actors in what often seems to be a timeless, placeless steady state. Unfortunately, that mode of analysis cannot tell us what specifically is modern or American about current U.S. employment practices. This void would not be a problem were there but negligible national or historical variation in employer policy. However, the evidence shows such variation to be substantial.

American employment practices have rarely matched the textbook model of a spot labor market. But, over the course of this century, those practices went through a transition. Employment relationships became markedly more stable, while internal labor markets and seniority-layoff systems proliferated (see Jacoby, 1983). Similarly, nominal wages in the United States never were completely flexible. But, during the 1910s and 1920s, nominal wage cuts were more prevalent (and wage sensitivity to labor market conditions was greater) than in the post-World War II period (see Mitchell, 1985).

Europe and Japan did not go through the same transitions. The relative reliance on layoffs, nominal wage change, and real wage change varies from country to country. These time-and-space departures from U.S. arrangements suggest that rationalizations based on current American practices cannot be the basis of universal theory.

Confronted with the specificity of their stylized facts, NEP theorists have three responses. One is to argue that observed variations are transitory disequilibria; eventually employers will shift from less to more efficient employment practices. Oliver Williamson (1985) makes precisely this argument for the American historical case, infer-

*Anderson Graduate School of Management, UCLA, Los Angeles, CA 90024.

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ring that present practices displaced earlier ones because of superior efficiency. But the inference depends on other assumptions. One is that market forces are always strong enough to weed out inefficiency. A second is that there is one right way to manage, that is, that multiple efficiency points do not exist.

Comparative observation suggests that multiple equilibria within a market setting are possible. On the one hand, critics of "Eurosclerosis" in the 1980s pointed to the American model of labor market "flexibility" (easy layoffs) as proof that European long-term job security was undesirable. At the same time, American management experts journeyed to Japan to marvel at long-term employment commitment and the ability it gave management to move workers to needed tasks.

A third response is to argue that any departure from current U.S. practices such as wage rigidity or career ladders must be due to variations in the incentives (for example, risk aversion, monitoring costs) that make those practices efficient. But historical research shows that, in the past, these incentives at least needed the push of social forces and historical accident (unions, wars, the Great Depression) to put now-existing practices into place. At the international level, economic rationality and technology (from which incentive structures should spring) are similar in modern industrial nations. So economic incentives can only be part of the story of historical and national variation in employer policies. The NEP either abstracts from such observations or, less often, stretches economic theory to endogenize them. A more fruitful approach would be to examine the interplay between institutions, incentives, and market outcomes, even if it means building partial models and acknowledging a limited ability to forecast.

II. Norms of Fairness

The institutionalists of the 1940s put great emphasis on notions of fairness in the labor market. For example, pattern bargaining in the union sector was seen as based on worker views of comparative equity. In contrast, NEP analysts would probably prefer to focus on reducing transactions costs in bargaining as a rational explanation for patterns. Yet there is other evidence that norms of fairness are important in labor markets. Moreover, these norms often seem to involve nominal—not real—measures.

TABLE 1—FORMAT OF REPORTED MAJOR PRIVATE UNION WAGE ADJUSTMENTS

	1959	1969	1979	1989
Nominal	69	83	80	68
Percent	12	12	19	25
Mixed[a]	15	2	1	1
Zero	2	0	0	6
Other	3	3	[b]	0

Source: Current Wage Developments, June issues of year shown.

Note: Percent in each category. Details need not sum to 100 due to rounding.

[a]Combined nominal and percentage description.

[b]Less than 0.5 percent.

Consider, for example, the annoying (to economists) tendency for union wage settlements to be reported in cents-per-hour terms rather than as percentage adjustments. Table 1 shows the proportion of private wage adjustments reported in the June issues of *Current Wage Developments* over the past three decades. Despite intervening episodes of significant inflation and wage guidelines and controls that emphasized percentages, the tenacity of wage setters in clinging to nominal expression of their settlements is noteworthy. The use of nominal expression suggests that when intersettlement comparisons are made for equity purposes, base wages matter little. That is, if two units receive 30 cent increases, workers in both feel that equity has been achieved even if one unit has a higher average wage (and therefore receives a smaller percentage increase). The tendency of escalator formulas to be specified in nominal terms (typically a cents-per-hour increase per index *point* increase) is a symptom of the nominal orientation. Employees apparently view wage relationships differently than do economists.

Survey data suggest a public aversion to nominal wage cutting. (Daniel Kahneman

TABLE 2—DISTRIBUTION OF EMPLOYEES UNDER MAJOR UNION WAGE SETTLEMENTS IN THE CONSTRUCTION INDUSTRY

	1980–81	1982	1983–84	1985–88
Decrease	0	5	13	3
Zero	0	10	41	26
0.1–1.9		3	16	16
2.0–3.9	7	10	8	27
4.0–5.9		16	7	20
6.0–7.9		17	6	
8.0–9.9	15	19	5	
10.0–11.9	21	11		7
12.0–13.9	17	4	3	
14.0 & up	39	5		
Mean Adjustment	13.4	6.5	1.1	2.3

Source: Current Wage Developments, various issues.
Note: Multiyear figures are weighted by annual number of employees covered. Percent in each category. Details need not add to 100 due to rounding.

et al., 1986.) While such aversion might be explained as a reflection of a rationally based implicit contract by NEP theorists, the fact that the concern is focused on the nominal wage (not the real wage) creates obvious analytical problems. Table 2 presents the distribution of union wage settlements in the construction industry during the 1980s, a period when the industry was especially prone to "concession bargaining."[1] The distribution shows a decided downward shift in mean adjustments beginning in 1982. Yet the distribution bunches at exactly the (nominal) zero level. While some workers did receive wage cuts, zero was clearly a resistance point for pay adjustments.

J. M. Keynes (1936, p. 14) was quite willing to accept fairness as a basis for apparent money illusion in the labor market; it formed a major element in the *General Theory*. In his view, decentralized wage setting led to a worker focus on comparative (nominal) wages, even if price movements eroded purchasing power. Would today's NEP analysts be willing to buy such an explanation? And even if he or she did, what would be done with the observation that the degree of real vs. nominal wage rigidity seems to vary across countries? The Keynesian vs. classical debate over European unemployment in the 1980s suggests that worker norms of fairness can change over time and vary across countries.

III. Changing Times

Although NEP provides a rationale for various anomalous facts first pointed out by labor economists of the 1940s and 1950s, it appears that this theoretical success has come just at the time when the facts themselves are changing rapidly. Labor markets are moving away from the rigidities captured by those facts. Having rationalized a difference between labor and product markets, NEP analysts must now consider the possibility of greater similarity across these markets than existed in the past.

Impelling the move away from rigid forms of employment are cost pressures arising from a more open and competitive economy. One response to those pressures was the wave of permanent layoffs that swept American industry during the early to mid-1980s, eliminating many previously secure jobs. Disproportionately affected were older, blue-collar, unionized, manufacturing workers. Managers have not been exempt from such cost-cutting moves.

A related development was the shift of employment during the last decade to smaller firms and establishments, where compensation is lower and personnel practices are less formalized. To compete, large establishments are using part-time employees or are contracting work out to the burgeoning business service industries that supply temporary workers and other business support services. While not all of the work being contracted out is done at lower wage and benefit costs, the bulk of business services are provided by lower-status workers whose pay is less than that of regular, in-house employees. Generally, full-timers are paid more than comparable part-timers, with the latter predomi-

[1] Construction is presented because most contracts in the industry do not feature escalator clauses or lump sum bonuses that obscure actually experienced pay adjustments. However, distributions similar to those of Table 2 characterized the entire union sector in the 1980s.

nantly made up of female clerical and service workers.

Part-time, temporary, and business service workers comprise the contingent labor force, each segment of which has grown more rapidly since 1980 than the labor force as a whole. In addition to cost factors, use of contingents has been spurred by an unstable and less predictable business environment, which results from more variable product demand, shorter product life cycles, and flexible exchange rates. Employers are trying to keep a lean core of employees with job security and to smooth out demand fluctuations by using contingent workers who lack such security.

Tenure data offer a way of tracing these shifts in employment stickiness. Table 3 shows that between 1963 and 1981, job tenure for men declined but there was little or no change for women or mature workers. Because workers can change jobs without changing employers, a more accurate gauge of employment stickiness is tenure with a given employer. This measure has been used by the Bureau of Labor Statistics since 1983, unfortunately breaking the older series. As shown in Table 4, between 1983 and 1987, groups experiencing sharp tenure declines included mature men (previously a stable group); male managers and machine operators; and female clerical and service workers. Those outcomes reflect an expansion in contingent labor and shifts of employment away from stable jobs in large firms.

Wages also are becoming less rigid and more sensitive to firm performance, despite the pressures emanating from norms of fairness. In 1986, profit sharing in medium-to-large firms stood at 22 percent of full-time employees. Lump sum bonuses, that hardly existed before the 1980s, were in the contracts of 51 percent of private, unionized, nonconstruction workers under major agreements in late 1988. There is some evidence (not definitive as yet) that these bonuses will prove more variable than wage rates and that they are a response (like contingent employment) to demand uncertainty (Christopher Erickson and Andrea Ichino, 1989). As variable pay methods spread, the kind of wage stickiness associated with long-term employment is likely to be reduced.

Why has the NEP literature been slow to recognize and acknowledge these changes? As in other fields, scholars tend to learn a given set of facts and stick with them. This tendency was characteristic of experts on Eastern Europe (who until recently insisted that nothing was changing in that part of the world) as well as U.S. industrial relations scholars (who were slow to recognize the pace of union sector shrinkage during the 1980s).

While slow response is not unique to NEP, it is nonetheless true that the NEP's static

TABLE 3—MEDIAN TENURE OF U.S. EMPLOYEES ON CURRENT JOB (YEARS)

	All Males	Males 45–54	All Females	Females 45–54
1963	5.7	11.4	3.0	6.1
1966	5.2	11.5	2.8	5.7
1968	4.8	11.3	2.4	5.1
1973	4.6	11.5	2.8	5.9
1978	4.5	11.0	2.6	5.9
1981	4.0	11.0	2.5	5.9

Source: U.S. Bureau of Labor Statistics, *Special Labor Force Reports*, various issues, and Bulletin no. 2162 (1983). Figures are for January.

TABLE 4—MEDIAN TENURE OF U.S. EMPLOYEES WITH CURRENT EMPLOYER (YEARS)

	Females		Males	
	1983	1987	1983	1987
All	3.7	3.6	5.1	5.0
25–34	3.2	3.1	3.8	3.7
45–54	6.9	7.3	13.2	12.3
Managers	4.6	4.9	7.5	6.9
Prof'l.	4.7	5.0	6.1	6.6
Sales	2.5	2.5	4.7	4.4
Clerical	3.9	3.7	[b]	[b]
Service[a]	2.8	2.5	[b]	[b]
Operators	[b]	[b]	5.6	5.1
Craft	[b]	[b]	5.5	5.5

Source: U.S. Bureau of Labor Statistics, "Job Tenure: 1983, 1987," unpublished tables. Figures are for January.

[a]Excluding protective service workers.
[b]Not one of the five largest occupations for that sex.

approach to theory is not well-suited for predicting outcomes of dynamic relationships, such as those between firms and their environments. As in other branches of economics, the NEP tends to give more emphasis to internal theoretical consistency than to external consistency with a welter of changeable facts.

IV. Where Do We Go from Here?

The NEP analysts have demonstrated something important; almost any behavior can be rationalized within the neoclassical framework. While the usual fallback is to use empirical testing to sort out the true explanation, such testing in practice rarely sorts out competing views definitely. Starting from stylized facts, if nothing else, prevents one from saying silly things about nonexistent phenomena. But neither institutionalists nor NEP theorists can base their observations on a set of stylized facts, and ignore trends which are changing those facts, without risking obsolescence.

Some physicists reportedly feel they are on the verge of a Theory of Everything, a unified theory that will encompass all known forces. But it is unlikely that such a theory will arrive for labor market analysts anytime soon. What we can hope for are informed but modest partial theories and explanations.

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