Comment on

Occupational Upgrading and the Business Cycle in West Germany

by Thomas Büttner, Peter Jacobebbinghaus, and Johannes Ludsteck

Ekkehart Schlicht*

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1 *Raising Controversy*

The "Comments and Questions" feature of the *Economics ejournal* and its related discussion paper series offers the possibility to raise controversy. I take the opportunity.

I shall explain why I think that this paper provides additional evidence against the dominant view entertained in labor economics that relies on the twin assumptions of well-defined markets for each grade of labor and of utility taking on the side of the employers. Instead, it supports the view proposed by Melvin Reder (1955) that firms respond *both* with adjusting wage offers and hiring standards to changing labor market conditions.

2 *The Paper*

Büttner *et al.* (2009) replicate the study by Devereux (2002) for Germany. The result obtained for the US–that hiring standards are adjusted to labor market conditions–is reconfirmed for West Germany. The data set used is extremely large and representative of the entire West German labor market. The analysis appears to be done extremely carefully. The paper follows Devereux's study closely, rendering the findings easily comparable. The result–that firms are more choosy if labor supply is ample and less selective if labor supply is tight–may seems unsurprising. Its theoretical significance, however, cannot be over-estimated. I hope that the paper encourages authors in other countries to do similar studies and thereby broaden the facts on which our theories and policy recommendations must build.

* Professor of Economics, Department of Economics, University of Munich, Schackstr. 4, 80539 Munich, Germany, www.lrz.de/~ekkehart.

It seems to be a wise decision by the authors to stick to their empirical findings and shun the broader discussion of the nature of labor market competition, and how to model it properly. This is best left to other studies. The first priority seems to establish the facts. The second step would be to interpret them.

3 *A Challenge*

Yet papers like this one challenge a core presupposition of standard labor market theory: The idea that each labor market deals with just one grade of labor, and wages are taken out of the market. This excludes, almost by definition, the phenomena of upgrading and downgrading of workers relative to jobs. Further, if firms tighten hiring standards when supply conditions improve, this means that they have latitude both in fixing the hiring standard and the wage level. (Without tightening the hiring standard in such situations, they could afford to pay less and make more profit. That they don't do that indicates that it is even more profitable to tighten hiring standards, even if this involves increased labor costs.) The authors follow Devereux and mention this issue only briefly without taking sides. I think this is a right decision on their part, but a paper like this one is interesting precisely it has implications for our view of the functioning of labor markets. It relates to fundamentals of labor market analysis. So let me comment on this issue.

The phenomenon of upgrading and downgrading lends support to Reder's view of labor market competition and puts into question the presupposition of utility-taking wage contracts for tightly defined grades of labor that is so widely entertained in standard labor market theory. I agree that this may not be a fully convincing criticism of standard theory. Standard theory is so flexible that it can account for everything conceivable by adding, as it were, another intellectual epicycle. The authors, following Devereux, are aware of that flexibility and offer some possible mechanisms that may account for their empirical findings within the orthodox line of thought. This may soothe the mood of orthodox readers..

Yet the present findings should be seen in context with other observations, and this seems to rule out such a catholic attitude. Consider unemployment rates for workers with different educational background and assume, as is the case in Germany, that the less educated workers face a higher unemployment rate than the better educated workers. If employment of both groups increases in proportion to production, the unemployment rate of the less educated will drop by *fewer* percentage points than that of the educated, but empirically, the opposite is true, see Figure 1. The bulk of employment changes falls on the less educated. They seem to be rationed out of employment not so much by decreasing wage rates, but rather by increasing hiring standards.

Further, an increase in employment will run into more pronounced shortages for the the group with lower unemployment, *viz.* the better educated workers. We would thus expect stronger wage reactions for the the better qualified workers, but empirically the opposite is true (Ludsteck and Haupt, 2007).

Both phenomena contradict what is to be expected if upgrading and downgrading of workers did not occur. With upgrading and downgrading, the observations are easy to interpret: Employment changes lead to upgrading and downgrading, with the effect that the strongest

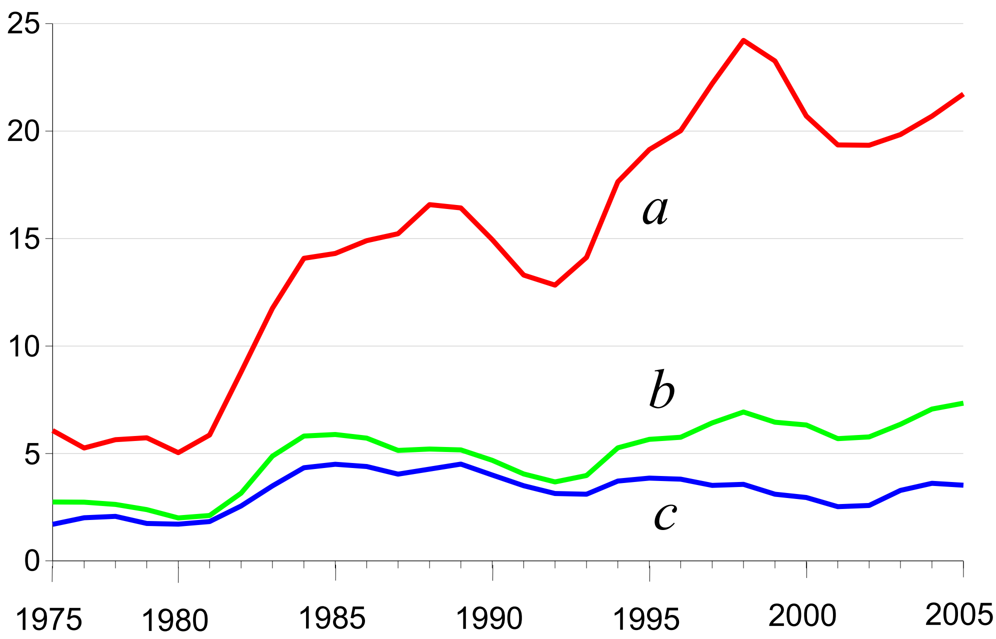

Figure 1: Unemployment rates in Germany according to educational background 1975-2005. (a) Workers without completed vocational or academic training, (b) workers with vocational training, and (c) workers with academic training. (Source: IAB, Institute for Employment Research, Nuremberg.)

employment changes, as well as wage changes, occur at the bottom of the wage distribution, just as Reder has suggested.

In conclusion, the analysis casts further doubt on the idea that labor markets are cleared by wage adjustments without adjustments in hiring standards.

Some minor notes:

1. The term "occupational composition wages" refers to the average wage brought about by a given employment structure while presupposing constant wages for all occupations. Hence changes in occupational composition wages result from a change in occupational structure. This kind of definition is given on page 19, while the term itself is used in the abstract and on page 3 without explanation. The authors may consider not to use the term before it is defined, and even think about a preferable term.

2. I find the layout of Table 1 a little confusing and would suggest placing a horizontal line between "Female" and "Low/intermed. school" and another horizontal line above "Daily wage." Further I would suggest to replace the headings "Skill composition regressions" and "Wage regressions" by "Sample used for skill composition regressions" and "Sample used for wage regressions." I would also appreciate a legend for Table 1 that explains what is listed in that table. (I am aware that this is also explained in the text, but I would welcome some redundancy here, as this may improve readability.)

3. The interpretation of the quintile results in connection of Table 4 is not quite transparent to me. Some help regarding the interpretation of these results would be welcome.

References

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