

# Reply to Referee Report of September 5

September 5, 2007

I thank the referee for reading the paper and for alerting me that I have to phrase things more carefully in order to avoid misreading.

## Main concerns

1. The entire point is based on misreading the paper. The referee interprets the reservation wage  $R$  as relating to the unemployed or people engaged in home production, whereas I have written (I quote the entire paragraph, where the reservation wage is introduced):

To capture labor heterogeneity and skill latitude, we consider just two grades of labor, *prolific* and *mediocre*. Both types of workers, the mediocre and the prolific, can perform the task under consideration, but with different efficiency: The prolific workers are more productive. Firms can distinguish the types costlessly when they hire them. Further we assume that the alternative employment for both types of workers is such that individual productivity differences do not matter—think of a conveyor belt. Their wage in this standardized employment functions as a reservation wage for the labor market under consideration. It is denoted by  $R$ .

There is no mentioning of the unemployed nor of people engaged in home production, and the paper does not relate to unemployment in any way. The misreading is maybe partially due to my poor way of expression myself. In a revised version, I shall try to improve the phrasing.

3. This should be resolved by considering that I tried to express a somewhat different idea from what the referee thought. Over-qualification means that people have qualifications that are not needed to perform the job they are holding. This would be the case for a person who obtained an education for a high-paying job (with wage rate  $W$  in the model) but works at a low-paying job (with wage rate  $R$  in the model)—an engineer at McDonald's for instance. This conforms to the use of terms in the literature I refer to, and I said at the

beginning that I do not wish to discuss the many questions that might arise in the context of defining and measuring over-qualification, but the references I give enlarge on these issues. I shall try to rephrase some passages such that possible ambiguities in meaning are reduced as far as is in my power.

4. It is true that I have not said anything about the hiring threshold. However, I commented on that as follows in the footnote on page 10:

Since there is no continuum of different workers with different productivity, firms cannot impose a hiring standard in this extremely simple setting, but the fundamental selection wage mechanism still applies: By increasing the wage offer, firms can attract more prolific workers and attain a higher productivity of their work force. For an analysis of the continuous case, see SCHLICHT (2005).

In the simple setting, any hiring standard between  $x$  and  $y$  would obviously do. The continuous treatment is provided in the referenced paper, available through a hyperlink in the paper, just as in this this reply, in order to help the reader to get the point.

Further, the referee asks how it can be that increasing over-qualification occurs together with an increase in non-routine cognitive tasks, and how this relates to training incentives. The paper was intended to propose a route for solving that puzzle. The last paragraph of the paper reads:

Factors that render differences between workers more important induce firms to place more emphasis on selection and to increase wages. Such factors are labor heterogeneity, skill latitude, or labor mobility. All these factors would give rise to the joint occurrence of inequality and overqualification.

This should be clear, and the mechanisms have been spelled out before: The wage level increases due to an increase in skill latitude, and this increases training incentives even if it is uncertain whether or not to obtain a high-paying job that requires the training.

I guess the problem relates again to the initial misreading noted under point 1.

The referee writes: “In this sense, the model does not really consider multiple-worker firms.” I don’t understand how this impression could arise in the referee’s mind, as it should be clear throughout that the representative firm hires both prolific and mediocre workers.

The referee writes: “In this sense, the model does not really consider [...] firms with declining marginal productivity or profitability.” This is correct. The case the referee has in mind is discussed in SCHLICHT (2005). I have abandoned in this paper these ideas and found a way of modeling firms without some usual but

problematic marginal productivity assumptions; I have, however, been rather quiet on this aspect of the model because it does not relate to my main concern but would open up a bees' nest, re-iterating the marginal cost controversy in the fifties and sixties. I consider the case that a firm has a certain number of jobs to fill. The standard view (taking the effective amount of labor as an argument in the production function) models a different production structure. The production structure I assume is different. I think it is more realistic (for quite a number of reasons), but even if it isn't, it may be of interest to consider this alternative. (Note that the defense of marginalism by Machlup and others was never that marginalism was realistic. Clearly mark-up pricing prevails, as any textbook on pricing tells, but marginalism was defended as an *as if* theory that derives correct results from incorrect premises, a methodological position now prevailing in macroeconomics, and not questioned in current microeconomics. I think it is misguided, but don't want to enlarge on that. The methodological position I take is certainly not dominant, but the issue is certainly controversial, and there is a large literature about it.)

The referee mentions again his or her concern that the hiring standard is not explicitly modeled. I refer to my comments above.

5. The referee writes: "The paper addresses the inherently dynamic question with a static model of the labor market." This is correct. It is a deliberate modeling choice. The benefit is simplicity. The objection would be that the argument becomes misleading because of its static nature. This objection has not been substantiated, and so I don't know what the answer to that objection would be. (As a general point, this kind of criticism relates to *all* static models, and in this sense, applies to an entire branch of theorizing. This would be controversial, to say the least.)

The referee writes: "Section 7 and section 9 are based on pure speculation." Well, maybe on less speculation than theories involving marginal cost pricing. In section 7 I indicate the evidence I am alluding to. The trend away from routine tasks is considered by many a well-documented trend. My proposal is to interpret it in a different way: An increase in skill latitude, rather than an increase in demand for advanced skills. The empirical point is here, as I noted, that this development has been observed on *all* skill levels which renders the usual interpretation wage dispersion through SBTC doubtful. In this I would propose that my thesis is slightly less speculative than the standard SBTC thesis. Section 9 argues that increasing job rents increase incentives for education, and people demand more education. This is pure speculation in the same sense that we speculate that an increase in a price makes a good more expensive and reduces demand (provided income effects don't interfere). Let it be. My argument was simply that the development becomes understandable if we build on such speculation. There is also evidence that skill premia increase and that the demand for education increases, outstripping what is needed by industry. The referee accepts that the argument makes sense but complains that it becomes very loose. I agree, but I would prefer leaving it as that. Elaborating may reduce

transparency, especially if dynamic aspects are incorporated. This may better be left to another paper. I am glad if the reader just grasps the idea.

6. “The model requires either unemployment or job separation in equilibrium.” This is again prompted by the misinterpretation mentioned under point 1. Otherwise I cannot understand this remark.

7. Again the misreading mentioned under point 1. crops up here. The model is admittedly simplistic. I put actually great effort into simplifying it. If people like complicated models, they may devise them. I see a model not as any kind of description of the real world or, even worse, as a minute investigation of an imagined problem in an imagined world, but as a way to transport an idea. The referee clearly entertains a different view. I think it is good for the profession to be catholic in this respect.

The argument about unemployment and market entry is again off the point.

8. The model may not be convincing. The idea was to present a way of interpreting the otherwise puzzling phenomena mentioned. The next step would be to look for empirical evidence, confirming as well as contradicting. The referee argues further that the model presented is “not in line” with the data. Well. It explains an increasing deviation between  $W$  and  $R$ , and the implicit argument is that this carries over to all wage differentials. I have to be more explicit about that.

#### **Minor points:**

Thank you for alerting me. I will do the appropriate corrections.

## **References**

SCHLICHT, E. 2005, “Hiring Standards and Labor Market Clearing,” *Metroeconomica*, 56, 263–79, online at <http://econpapers.repec.org/paper/izaizadps/dp481.htm>, (preprint).