

**FDI, Skill-Specific Unemployment, and Institutional Spillover Effects (MS#664).  
RESPONSE TO THE INVITED READER COMMENT**

Thank you very much for the numerous excellent suggestions, which have helped a lot to improve the paper. As you will see from the revised paper and the attached responses to your and the referee's concerns, I have addressed most of the comments on the previous draft. The introduction is completely rewritten and major parts of the paper are also new. The focus of the paper shifted away from foreign direct investment towards the effects of institutional reforms on global competitiveness. That is also the reason why the title changed to "Skill-biased labor market reforms and international competitiveness".

One of your main concern was the empirical relevancy of skill-specific labor market institutions. Following the lines proposed in your comment, more examples for labor market institutions that can have skill-specific effects on workers are briefly discussed in the text. Examples include minimum wages, unions that are stronger in more low-skill intensive industries due to a higher number of union members and others. I also improved the search and matching framework by distinguishing between the flow value of being unemployed and unemployment benefits in line with Pissarides (2000). The German labor market reform (Hartz IV) for instance affected all workers' replacement rate and was thus not skill-specific. Nevertheless, a reduction in unemployment benefits may have different effects on different type of workers through their relative importance. High-killed may be less concerned about job losses compared to low skilled, which may also result in skill-biased effects of institutions even through they are not skill-specific.

I also improved the motivation on why we need two different skill groups: The answer is *to match the stylized facts found in the data*:

The stylized facts for Germany presented in Dustmann et al. (2009) suggest that wage growth at the bottom of the distribution were stagnant or even negative, whereas wages at the top of the distribution were rising shortly after 2000. A reduced outside option for workers due to a labor market reform is a potential explanation for stagnating or even decreasing wages if workers have to search for employers and if unemployment is high. The less likely reemployment in case of job separation, the more important the outside option gets for a worker. Rising wages at the top of the distribution suggest little impact of those institutional reforms in the high income group. The model in this paper distinguishes between low- and high-skill workers but unemployment benefits for instance are modeled as flow values. Thus, an equal change in unemployment benefits equally affects both skill groups, which is highly unrealistic. We address this issue by assuming that unemployment benefits of the high-skilled remain unaffected by the labor market reform. Workers at the top of the income distribution may have more assets that are generated outside the firm which should be accounted for in the flow value of being

unemployed. This is a shortcoming of the standard search and matching framework with more than two skill-groups.

The following points were also fixed:

1. The discussion of the effects of institutional changes on inequality is extended. I have to admit that that the discussion of inequality was too short and unclear in the first version.
2. The wording on the different production stages was streamlined.
3. Iranzo et al. (2008, Journal of Labor Economics) show that production and non-production workers are compliments (between group), which supports the choice of a Leontief production function. I added a short discussion in the paper.

I hope you like the revision.

Best regards,

Hans-Joerg Schmerer

## References

- [1] DUSTMANN, C., J. LUDSTECK, AND U. SCHÖNBERG (2009), “Revisiting the German Wage Structure,” *The Quarterly Journal of Economics* **124**: p. 843-881.
- [2] IRANZO, S., F. SCHIVARDI, AND E. TOSETTI (2008), “Skill Dispersion and Firm Productivity: An Analysis with Employer-Employee Matched Data,” *Journal of Labor Economics* **26**: p. 247-285.
- [3] PISSARIDES, C.A. ( 2000), *Equilibrium Unemployment Theory*, 2nd edition, Cambridge, Mass: MIT Press.