Studies in
Contemporary Economics

Heinz König (Ed.)

Economics of Wage Determination

Springer-Verlag
Berlin Heidelberg New York
London Paris Tokyo Hong Kong

Editor

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ISBN 3-540-52324-3 Springer-Verlag Berlin Heidelberg New York
ISBN 0-387-52324-3 Springer-Verlag New York Berlin Heidelberg

Printed in Germany

Printing and Binding: Weihert-Druck GmbH, Darmstadt.
2142/3140 - 543210 - Printed on acid-free paper

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Efficiency Wage Contracts, Worksharing, and West German Unemployment

A Comment on F.R. FitzRoy

Ekkehart Schlicht

This is a stimulating paper on an important topic; namely short-term versus long-term employment contracts and their impact on employment and efficiency. Short-term contracts permit employment responses to exogeneous shocks and might even - as argued by FitzRoy - lead to an optimal response in working hours (work sharing), but they involve some costs insofar as the firms must create incentives to assure sufficient effort. This leads to efficiency-wage unemployment. Long-term contracts might solve the incentive problems without using efficiency wages and associated unemployment and might also have efficiency advantages with regard to the creation and use of firm-specific human capital. It is argued that German unemployment is due to inflexible wages, brought about by inflexible institutions, centralized bargaining and egalitarian wage policies, rather than being attributable to efficiency wages or long-term contracting. Since I cannot discuss here the many arguments presented in this paper, I shall concentrate on a few points which seem to me to deserve some attention.

Although I agree that long-term employment contracts might have important efficiency advantages in terms of incentives and specific human capital formation, there are also important draw-backs: A world of life-time employment sentences without co-determination seems to me not that attractive. It is good for those who were lucky at the beginning of their career, but it is not so good for those who started their career in the wrong firm or in the wrong industry: They are locked in. Equalizing forces and allocative efficiency of labor might be better under a system of short-term employment contracts.

On the other hand, I find efficiency wage theories probably realistic but for other reasons than those given in traditional economics, as I try to explain elsewhere in this volume. Formulations like FitzRoy's equation (3), although quite general, seem to be rather ad-hoc and presuppose from the outset that wages control efficiency and mechanisms other than long-term employment contracts are simply inconceivable. I doubt this assumption. In the turnover case, e.g., a simple tax on turnover, payable by the employees, would create sufficient immobility to rule out unemployment (see Schlicht 1978). The same argument applies to the Shapiro/Stiglitz (1984) discipline case, and there seems even not to be a general presumption that equivalent regulations could not be introduced by self-interested agents in order to exploit - and thereby eliminate - the inefficiencies which would be associated with efficiency-wage unemployment. It is true that these changes might turn short-term into long-term contracts, but it illustrates that there is no presumption either which rules out a smooth change of labor contracts between short-run and long-run in response to preferences and technology, and hence no presumption for inefficiencies arising from non-convexities. (Actually, labor contracts of both types coexist in Japan as well as in Germany.)

Is it true, however, that the main source of German unemployment must be seen in "rigidities" rather than in efficiency wages? (I agree with the other assertions.) To my mind, efficiency wage theory has been concerned with the *explanation* of what *appeared* as rigidities. In other words, efficiency wage theories of unemployment tried to reveal the economic function of unemployment which precludes its elimination by expansionary fiscal and monetary policies, and the fear that such a policy will increase inflation rather than increase employment must have its rationale in a kind of efficiency-wage theory, if it has a rationale at all.

More down to-the-earth it could be argued that centralized bargaining has its advantages, too: The unions are forced to take economy-wide consequences into account; bargaining costs as well as moral havoc are minimized (as compared to firm-level-bargaining); price-taking behavior is simulated; and equity and solidarity concerns are, after all, real concerns which might lead to even worse outcomes if unchanneled by centralized bargaining (Akerlof and Yellen 1987).

I shall leave it at that. After all, I have not made up my mind yet with regard to the points mentioned as well as to numerous other points made in the paper. There might well be inefficiencies, and if we understood them we might design policies to cope with them. The main contribution of this paper is, it seems to me, to raise these points in a constructive fashion.

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