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Program Report

Labor Economics

Richard B. Freeman*

When the NBER instituted the Labor Studies Program some 20 years ago, labor economics was merely a tributary of economics. The main battleground of economic debate was macroeconomics, and most analyses focused on time-series data. Today, many of the big issues in economics are microeconomic labor problems, and their resolution requires analyses of large datasets. The topic that has attracted the greatest attention among NBER labor researchers is the change in the U.S. earnings distribution—the decline in the economic position of low-skilled workers relative to high-skilled workers—an area in which our colleagues in trade also have worked intensively. Many other labor issues, such as the effect of the minimum wage on employment and income, the effect of government training programs on worker skills, the relation between family background and the well-being of children, the return to schooling and even crime, can be viewed as part of a broad concern for the causes and consequences of inequality.

The high level of employment in the United States also has attracted much attention. Many Western Europeans look longingly on the "U.S. model" for its success in creating jobs. By the U.S. model, they do not mean U.S. macro or financial policy, or industrial organization, or trade policy; they mean our labor market. This is a significant change in thinking about the U.S. job market. Until the mid-1980s or so, the United States had higher unemployment rates than most European Union countries; the rate of joblessness in West Germany did not rise above the American rate until the 1990s. An Australian economist once remarked that when he was a student, he thought economic models based on the competitive U.S. labor market proved how badly economists understood labor markets. After all, Australia and Western Europe had markedly better unemployment records than the United States. But this

The NBER Working Papers and Technical Papers cited in brackets by number throughout this report are listed, and their abstracts and in many cases full text are available, at the NBER World Wide Web Site.

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is no longer the case. We may still misunderstand labor markets, but the facts that need explaining now are quite different.

NBER researchers have been examining foreign labor markets, and economic systems more broadly, in an effort to understand differences in outcomes across countries and to cast light on the virtues and vices of the U.S. labor market. They also have analyzed the organization of firms, asking what leads them to treat workers differently, and how labor relations and personnel policy, including compensation policy, contribute to firm performance.

Finally, mirroring the more central role of labor issues in economic analysis, the NBER Labor Studies Program has produced an extraordinarily large number of research papers since my last report (307 by my rough count), which made the preparation of this article more difficult than previous reports on the Program. Because of the plethora of papers, I have picked only some of the topics covered in the Program.

Further mirroring the increased importance of labor issues, the last two John Bates Clark Award medalists—David Card and Kevin M. Murphy—come from our ranks, of which we are proud.

Inequality and Related Issues

There is probably not a nook or cranny in the analysis of the rise in inequality in earnings in the United States that NBER researchers have not explored. They have contributed to documenting the facts [5202, 5832, 6213, 5823]; to examining the effects on immigration and how immigrants have fared in the economy [4972, 4955, 4866, 5454, 5763, 5927, 5388, 5837, 6195]; considered the role of trade [5924, 5940, 5621, 6209], unionization, technology [4255, 5534, 5956, 5107, 5941, 5606, 5657, 6166], in-

creases in the supply of women and the labor supply responses of the family [5236, 5459]; and looked at the effect of neighborhoods and ethnic capital on outcomes [6175, 6176]. Whereas in some parts of the profession, the inequality issue is posed solely in terms of the effects of trade versus technology, labor researchers have been looking at diverse institutional influences as well [4224, 4678, 4945, 5093]. A nutshell summary of this research is that there is convincing evidence that most things that we expect to matter **do** in fact matter; that no single factor can explain the pattern of rising inequality; and that consensus about the relative magnitudes of different factors has not been reached. As in much economic analysis that seeks to determine the "sources of...", there is a sizeable residual, leaving an open field for judgement calls. An important tool in these analyses has been the NBER's CD-ROM on the out-going rotation group of the Current Population Survey.

Women have been the "exception to the rule" of rising earnings differentials; they have improved their position in the job market, particularly at the higher skill levels. A significant number of researchers have explored the improved position of women in the job market and the particular problems they face. These researchers have sought new ways to assess issues relating to the determinants and consequences of childbearing [4911, 4224, 5664, 5406, 5778, 6047, 6034]; examined the effect of school content [5580] and faculty composition [4874] on female progress in the job market; and looked at the changing pattern of organizing careers and families [5188], and why women are underrepresented in the field of economics [5299]. Francine Blau and Lawrence Kahn have linked gender pay differentials to the overall wage structure across countries [5664], highlighting the exceptional progress of American women.

How much might additional schooling help the workforce prospects of persons from low income backgrounds? Does class size matter in student performance after graduation and in the job market? Researchers have used data on twins, sought distinct "natural experiments," and used cross-state data and diverse instruments to study the effects of these inputs on educational outcomes [4874, 5144, 5708, 5450, 6051, 5331, 5353, 5274, 5288, 5548]. One important finding is that the instrumented, or natural experiment, estimates of school effects on earnings show that they remain relatively high. The effect of class size and resources on schooling is more controversial; there is no consensus there. Cecilia Rouse has given a modestly positive assessment of the effects of the Milwaukee parental choice program on student achievement [5964].

How much might family background matter in economic differences? Joseph Altonji, working with various co-authors, has examined both the effects and mechanisms by which family characteristics influence the young [5072, 5378, 5522]. Derek Neal has presented evidence that "pre-market factors" are very important in black-white differences [5124]. Several researchers have examined childbearing issues [5807, 5781] and the effect of various programs and interventions on children's well-being [5805, 5985]. Janet Currie currently heads the NBER's Program on (the Economics of) Children.

What is the link between crime and economic problems? Several researchers have explored issues relating to crime, examining the distribution of crimes across cities [5430]; the relation between crime and wages [5983]; domestic violence [4939]; and employment and crime [4794, 4910, 5451].

Labor Institutions

Following the completion of the NBER's Comparative Labor Project in 1995, many NBER researchers have continued to study labor markets in countries outside the United States [5237, 5003]. Robert Topel and I, working with Birgitta Swedenborg of SNS, directed a major study of the Swedish welfare state, that paired Swedish and American researchers: *The Welfare State in Transition: Reforming the Swedish Model* published by the University of Chicago Press for the NBER in 1997. This project highlighted both the pluses of the Swedish model (conquering poverty) and the negatives (in the form of microeconomic inefficiencies and the inability to escape high levels of unemployment in the 1990s). John Abowd, working with Francis Kramarz, David Margolis, and others has exploited fairly unique data files from France that follow workers across firms [4917, 5077, T180, 5493, 5551, 6109, 6110], allowing the researcher to control for firm and worker effects and thus to learn more about how the job market functions. In 1995, Abowd helped organize an international conference on the use of matched employee-employer panel datasets. Other researchers have examined German institutions in some detail [5988, 4808, 4825, 5716, 5724, 6167, 5208, 5829] and have contrasted the United States, Canada, and France [5487]. In winter 1996 the NBER held a conference, organized by David Blanchflower and me, on youth labor markets. It contrasted the United States and Germany, the United Kingdom, and Sweden [6031, 6078, 6102, 6105, 6111, 6142, 6212].

Looking at U.S. institutions per se, Patricia Anderson and Bruce Meyer have focused on unemployment insurance, which has a surprisingly low take-up rate in this country [4787, 4960] while Kate Baicker, Claudia Goldin, and Lawrence Katz [5889]

have studied the development of that system over time. Jonathan Gruber, with co-authors, has examined the implications for labor supply of various social insurance programs [6041], while John Bound with co-authors has focused on disability insurance [5159, 5536, 5169].

Labor Demand and Firm Behavior

Many researchers have examined labor demand behavior and the internal organization of firms. Lawrence Katz has shown that wage subsidies can modestly improve the demand for disadvantaged workers [5679]. Daniel Hamermesh has examined the demand for hours of labor [4394, 5973]. Michael Kremer and Eric Maskin offered a demand-side analysis linking rising inequality to segregation by skill [5718]. Two studies have focused on worker characteristics, one on their impact on plant-level production [5626] and one on the effect of affirmative action on employee qualifications [5603].

Several researchers have looked at intrafirm issues, ranging from the theory of works councils and worker share ownership and worker cooperatives [4918, 5436, 6118] to other organizational issues [5705, 5802] to empirical studies of firm performance under alternative structures [6120, 5672]. Doug Kruse and Joseph Blasi have summarized what we know from many studies of the links among employee ownership and firm performance and employees' attitudes [5277]. Casey Ichniowski, Katharine Shaw, and Giovanna Prennushi have provided evidence that packages of human resource practices add more to firm productivity than individual practices [5333]. Robert Gibbons and Henry Farber organized a 1996 NBER-Universities Research Conference around the issue of the internal structure of firms, and this promises to be a growing topic in future years.

Econometric Issues

Huge datasets raise new potential for statistical testing and open the door for new strategies for determining behavioral responses to economic incentives. A striking pattern in much empirical work is the search for appropriate "instruments" from which to infer behavior. What researchers do is seek out factors that shift supply or demand incentives without directly affecting the relevant outcomes. Joshua Angrist, Guido Imbens, and Don Rubins have greatly enhanced our understanding of the advantages and limitations of instrumental variable analyses with a set of papers developing the notion of a local average treatment effect, or LATE [T118, T127, T181, 5192]. Angrist, Krueger, and Imbens have examined different ways to use instrumental variables [T150, T181, T172] while John Bound and David Jaeger have pointed out problems when instruments are only weakly correlated with the explanatory variable [5835]. James Heckman and co-authors have provided insightful analyses of the problems with social experiments [T166, T184, 5535].

What Next?

A visitor to labor studies from the rest of economics will notice immediately that the field is strikingly empirically-oriented, with researchers reacting to ongoing social problems and devoted to the "facts, ma'am, just the facts." This is a huge strength, but also in some ways a weakness. In the future, I expect more attention to be paid to the effects of trade on the labor market and to the contribution of labor markets to the distinct macroeconomic performance of the United States, which some researchers have explored [5822, 5538, 5538] and to further work on firms and institutional differences among countries. As it is difficult to analyze trade, macro issues, firms, or country institutions without some (albeit very different) theoretical basis, perhaps we will see labor researchers contributing more along the theoretical than they have in the past.

LIST OF SELECTED REFERENCES

For the rising pay of higher level workers, see:

WP 6213, 10/97, Brian J. Hall and Jeffrey B. Liebman
"Are CEOs Really Paid Like Bureaucrats?"

For the contribution of institutions to the distribution of wages, see:

WP 5093, 4/95, John DiNardo, Nicole M. Fortin, and Thomas Lemieux
"Labor Market Institutions and the Distribution of Wages, 1973–1992: A Semiparametric Approach"

For the effect of institutions on productivity and firm performance, see:

WP 5333, 11/95, Casey Ichniowski, Kathryn Shaw, and Giovanna Prennushi
"The Effects of Human Resource Management Practices on Productivity"

WP 5436, 1/96, Edward P. Lazear and Richard B. Freeman
"Relational Investing: The Worker's Perspective"

For the debate over the role of school resources on education, see:

WP 5708, 8/96, David Card and Alan Krueger
"School Resources and Student Outcomes: An Overview of the Literature and New Evidence from North and South Carolina"

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WP 5548, 4/96, Eric A. Hanushek, Steven G. Rivkin, and Lori L. Taylor
"Aggregation and the Estimated Effects of School Resources"

For macroeconomic issues, see:

WP 5822, 11/96, Olivier Blanchard and Lawrence F. Katz
"What We Know and Do Not Know About the Natural Rate of Unemployment"

For social insurance issues, see:

WP 5889, 1/97, Katherine Baicker, Claudia Goldin, and Lawrence F. Katz
"A Distinctive System: Origins and Impact of U.S. Unemployment Compensation"

WP 6041, 5/97, Jonathan Gruber and Aaron Yelowitz
"Public Health Insurance and Private Savings"

Research Summaries

Monetary Policy and Inflation Targeting

Lars E.O. Svensson*

In the 1990s, several countries shifted to a new monetary policy regime: an announced quantitative inflation target. The reason for this shift was the unsatisfactory performance under previous regimes. New Zealand, Canada, Australia, and Spain all introduced inflation targets under persistently high inflation; the United Kingdom, Sweden, and Finland did so after having abandoned fixed exchange rates, which had failed to achieve low and stable inflation and had been subject to dramatic speculative attacks. Inflation targeting has received much recent attention, both among policymakers and academics. In the United States and in Europe it is debated as a possible monetary policy strategy for the Federal Reserve System and the future European Central Bank, respectively. Academic research on inflation targeting, both theoretical and empirical, has grown quickly.[1] My own research in the last few years has largely dealt with understanding inflation targeting in relation to other monetary policy regimes and investigating how practical monetary policy can best be conducted under inflation targeting.

Practical inflation targeting has several common characteristics: 1) an announced quantitative inflation target, varying across countries between 1.5 and 2.5 percent per year, in most countries with a tolerance band of plus/minus 1 percentage point around the target; 2) no explicit rule on how the central bank shall set its instrument; 3) a floating exchange rate (except for Finland and Spain, which are members of the Exchange Rate Mechanism, although the wide exchange rate bands there so far have not created any conflict between the inflation target and the exchange rate target); and 4) a high degree of transparency and accountability. Commentators also often describe inflation targeting as a regime without an intermediate target for monetary policy (instead, targeting inflation "directly"). I have argued in some of my research that this is misleading and that inflation targeting actually implies a particular intermediate target, namely the central bank's inflation forecast.

Inflation Targeting as a Remedy Against High Inflation

Inflation targeting can be seen as a potential remedy for persistent high inflation. Other remedies discussed and suggested in the literature include: 1) accepting that the long-run Phillips curve is vertical and implicitly, or explicitly, setting any output or employment target equal to (rather than above) the "natural" level; 2) creating an independent and conservative central bank; and 3) setting up a performance contract (an "inflation contract") for the central bank governor or governing board. In one of my papers, I examine the relation between inflation targeting and these remedies. Inflation targeting indeed can involve elements of all three remedies. By announcing a rather low inflation target and creating some degree of commitment to it, inflation targeting can help to reduce inflation, even if an inflationary bias remains, and if inflation more often exceeds than falls short of the target. This creates a "conservative" central bank in the sense of having a *lower inflation target* rather than, as is common in the literature since Rogoff's classic 1985 article, identifying "conservatism" with a *larger weight* on a *given* inflation target.

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