Volume 9 | Number 1 Article 2

1-1-2002

The New Employment Contract?

David I. Levine
University of California, Berkeley

Citation

Levine, David I. 2002. "The New Employment Contract?" Employment Research 9(1): 4–6 https://doi.org/10.17848/1075-8445.9(1)-2

W.E. Upjohn Institute for Employment Research
Employment Research - January 2002
David I. Levine

The New Employment Contract?

Economists often assume markets set wages. On the contrary, for most Americans, employers set their wages within an internal labor market that is often only weakly associated with a spot market. A characterization of internal labor markets back in the 1960s and 1970s might be that they provided an implicit employment contract that exchanged employees' hard work for employment security. For lack of a better term, we refer to that arrangement as the "old employment contract."

During the last decade, the media have proclaimed the death of the old employment contract and a new emphasis on flexibility and external, not internal, labor markets. In fact, this pronouncement is overstated, if not incorrect. As Samuel Clemens remarked upon seeing his obituary, "The news of my death is greatly exaggerated." Data do show that employment security may be tempered. However, while tenure is a bit shorter on average than it used to be, the declines are modest for most groups of workers.

While past research has emphasized the length of jobs as a measure of the strength of internal labor markets, it is also important to understand the evolution of complementary measures; the divergence of pay in the internal and external labor markets. In a forthcoming Upjohn Institute book (Levine et al. 2002), we present an exhaustive study using five distinct sources of data, including a unique data set with information on employers and employees in both the United States and Japan and a new survey on fairness in employment. We examined changes in internal labor markets, company pay structures, and the employment contract. Our conclusion is that, as far as the wage setting process is concerned, there is very little confirmation of the existence of a "new employment contract."

The Old Contract

In the classic old employment contract, especially at large employers, wages were not strongly responsive to the labor market. Instead, each company had a distinctive company wage level and pattern. The implications of these patterns were as follows:

1. Large employers pay higher wages;
2. Large and small employers reward employee characteristics such as age and education differently;
3. Wage levels of large and small employers within a region are only weakly related;
4. Wage levels among large employers within a region have large and persistent deviations from each other;
5. The pattern of pay differentials inside an internal labor market often differ from those in the external labor market;
6. Large employers hire higher-skilled employees and those from demographic groups managers preferred; and
7. Employees hold strong norms against almost any type of pay cuts.

Our study finds that these implications are supported in the data from the 1960s to the mid 1980s.

Have Institutions and Wage Structures Weakened?

The standard reading of recent business history suggests that the wage structures associated with internal labor markets (as described by Doeringer and Piore in their1971 work) weakened between 1980 and 1996 (e.g., Cappelli 1995). If internal labor markets have declined, we should be able to answer "yes" to all of the following questions. Our analyses did not find this confirmation.

1. Did wage levels at large and small employers become similar? Yes, but modestly. The wage gap paid apparently similar employees at large (over 1000 employees) and small employers (under 100 employees) declined from 18 percent in 1979 to 14 percent in 1993.
2. Did the returns on education and tenure in large and small employers converge? No.
3. Did the correlation between average wages in a local labor market and large company wages rise? No. In neither the Current Population Survey (covering 1979 to 1993) nor the Hay data set (1986 to 1992) did the correlation between average wages in a local labor market and large company wages rise.
4. Did inequality across employers decline? No. The standard deviation of employer wage effects remained near 11 percent in both the Cleveland Salary Survey (CSS) and Hay data sets. In addition, the persistence of employer wage effects remained similar in the 1990s as in the early 1980s (CSS).
5. Did the distinctiveness of wage patterns within an employer decline? No. Among large employers, the variability and persistence of distinctive internal wage structures remained constant from the early 1980s to the 1990s (CSS). Similarly, the differentials large firms paid for more education, age, and other worker characteristics did not come to resemble the differentials that small firms paid.
6. Did sorting of employees decline? Unclear. In the Hay dataset, sorting of skills was similar in 1986 and 1992. In the Current Population Survey, with the exception of race, differences in the characteristics of employees at large and small employers either remained constant or converged substantially between 1979 and 1993. In the CSS, the correlation between an employers' average wage (conditional on its occupation mix) and the mean wage of entry-level occupations rose by an economically meaningful amount.
7. Have attitudes changed to be more accepting of the vagaries of the market? No. Our study repeated questions about the fairness of pay cuts that were asked in a Canadian study in Vancouver and Toronto in the mid 1980s (Kahneman, Knetsch, and Thaler 1986). When we surveyed workers in those two Canadian cities as well as in Silicon Valley in the United States in 1997 and 1998, the acceptability of a pay cut was almost identical.

Implications for Theory

Our results are surprisingly unsupportive of any single story about changes in wage structures at large U.S. employers. Human capital theorists posit a tight relationship between skills and wages.

Consistent with the hypothesis that returns to human capital have risen, returns to measures of skill such as education, tenure, mean occupational education, and Hay points rose in the 1980s and 1990s.

Nevertheless, most of our results are inconsistent with human capital explanations for wage differentials among employers (Juhn, Murphy, and Pierce 1993; Davis and Haltiwanger 1991). In the early period, controlling for skills did not systematically reduce the estimated wage gap between high- and low-wage employers (Hay, CSS, U.S.A./ Japan). Moreover, controlling for measures of skills did little more (CSS) or nothing more (Hay) to undo the rising inequality among employers. High-wage employers remain high-wage employers even with very detailed controls. These results challenge *all* theories of wage determination.

An important question motivating our work was whether rising wage inequality is related to weakening internal labor markets. Studies using longitudinal data on individuals conclude that rising inequality appears to be due to job changes, not to rising pay variance within a career at a single employer (Gottschalk and Moffit 1994). Our study did not examine longitudinal data sources, but consistent with the past research, we found no increase in variability within employers' wage structures over time, implying more is at risk when people change jobs.
s far as the wage setting process is concerned, there is very little confirmation of the existence of a "new employment contract."

Our findings of unchanged wage-setting rigidities (on average) pose a puzzle for institutional theories of these rigidities. Most of the rigidities (employer wage effects, size-wage effects, etc.) have historically been linked to unions and to product markets characterized by oligopolies, regulation, and limited international competition. The last quarter of the twentieth century witnessed a decline in all of these product-market rigidities, but without a corresponding decline in rigidities in compensation outcomes examined here. These findings suggest that fairness considerations and other micro-level determinants of bargaining power and the payoff to efficiency wages may play a relatively larger role in determining wage patterns and rigidities than many researchers previously thought.

Implications for Managers

The rhetoric of the new employment contract suggests that employers and employees now accept external labor markets as the best way to organize employment. Our survey results show that employees' norms toward pay cuts and layoffs remain consistent with the traditional employment contract. Moreover, companies' pay policies, presumably in part reflecting this stability in norms, do not appear vastly more flexible or market-oriented than in years past.

For managers, our results suggest that traditional internal labor market policies such as minimizing layoffs may still be useful in promoting high levels of skill and effort. Moreover, when layoffs are necessary, employees accept them more if they are due to external causes such as low sales, if top executives share the pain, and if the firm provides notice and assistance.

Implications for Public Policy

Employment-related policies in the United States have often been linked to the old employment contract. For example, the United States is the only industrialized nation in which an employee's pension and health insurance depend on his or her current employment relationship. Training decisions after college are largely determined by a worker's current employer, with no visible means of certifying to future employers what was learned on the job. Affirmative action policies have emphasized increasing employment of underrepresented groups in large employers, based on the assumption that jobs at large employers have above-average career prospects. Unemployment insurance and protection from many other labor laws often do not apply to workers with short-term or nonstandard relations with their employer.

Does our argument that the new employment contract is not much different from the old contract imply that changes in employment-related policies are moot? Not at all. While mobility and flexibility have not shown marked increases, North American labor markets have always had high mobility. Thus, public policies based exclusively on the old model never fit the careers and lives of many Americans. For example, it never made sense for health insurance and pensions to have been based on a model of lifetime employment at a single firm. Instead, public policies should encourage portability of pensions and health insurance. Government connection to learning should never have stopped after college; instead, the government should oversee a system of industry-designed certifications for general skills.

At the same time, the results in our study imply that labor market policy should not abandon the focus on creating stable jobs. While few employers can assure lifetime employment, most employees still value the predictability and relationships that come from long-term employment.

David I. Levine is an associate professor at the Haas School of Business at the University of California, Berkeley.

Suggestions for further reading

Cappelli, Peter. 1995. "Rethinking Employment." *British Journal of Industrial Relations* 33: 563–602.
Davis, Steve J., and John Haltiwanger. 1991. "Wage Dispersion between and within U.S. Manufacturing Plants: 1963–86." *Brookings Papers on Economic Activity, Microeconomics* 115–200.

Doeringer, Peter B., and Michael Piore. 1971. *Internal Labor Markets and Manpower Analysis*. Lexington, Massachusetts: Heath.

Gottschalk, Peter, and Robert Moffitt. 1994. "The Growth of Earnings Instability in the U.S. Labor Market." *Brookings Papers on Economic Activity* 2: 217–272.

Juhn, Chinhui, Kevin M. Murphy, and Brooks Pierce. 1993. "Wage Inequality and the Rise in the Returns to Skill." *Journal of Political Economy* 101(3): 410–442.

Kahneman, Daniel, Jack Knetsch, and Richard Thaler. 1986. "Fairness as a Constraint on Profit-Seeking: Entitlements in the Market." *American Economic Review* 76: 728–741.

Levine, David I., Dale Belman, Gary Charness, Erica L. Groshen, and K.C. O'Shaughnessy. Forthcoming. *How New Is the "New Employment Contract?"* Kalamazoo, Michigan: W.E. Upjohn Institute for Employment Research.