Remarks by Steven J. Davis on:

“Wage Rigidities and Jobless Recoveries”
by Robert Shimer

“From Wages to Welfare: Decomposing Gains and Losses from Rising Inequality” by Giovanni Violante (with Jonathan Heathcote and Kjetil Storesletten)

Econometrica Society World Congress
Shanghai, China
19 August 2010
Capital Destruction (Obsolescence) Shocks and Wage Rigidities

• Shimer considers the potential for capital destruction shocks and wage rigidities to improve the ability of near-canonical models to explain aggregate fluctuations in employment, consumption and investment
  – Comovement, amplitude, propagation
  – Dynamics of labor market flows

• I see both model elements, separately and in combination, as promising and well worth exploring.
Capital Destruction and Adjustment Costs

• Den Haan, Ramey and Watson (AER 2000) consider an MP-style model with endogenous job destruction and specific forms of physical capital.
  – Endogenous destruction margin amplifies and propagates aggregate response to productivity shocks
  – Capital adjustment costs further increase the propagation of productivity shocks.
On Capital Destruction Shocks

- Real-world shocks such as the financial crisis of 2007-2008 may be best mapped to tied shocks in dynamic equilibrium models of aggregate fluctuations:
  - E.g., capital destruction at some production sites coupled with a broad impairment of financial intermediation in the economy (or a widespread TFP decline in a reduced-form representation)
  - This type of paired shock may deliver a persistent drop in employment, consumption and investment with a sharp short-lived spike in job destruction + a long, drawn-out decline in job-finding rates.
On Wage Rigidities

- Wage stickiness is a powerful source of amplification and propagation in dynamic equilibrium models (Shimer, Hall, others).
- Indeterminacy of equilibrium wage in standard search models offers one rationale for stickiness:
  - Appeal: Addresses the Barro critique (JME 1977).
  - How robust is the indeterminacy result? (Hall, JPE 2009). Is it empirically relevant?
  - How concerned should we be about Barro critique?
On Wage Rigidities

- The indeterminacy result does not appear to help on the destruction/separation margin.
  - Standard search and matching models fail miserably in accounting for the apparent magnitude and persistence of earnings losses in the wake of job loss. See, e.g., Davis comments on Hall (2005 NBER Macro Annual) and Den Haan, Ramey and Watson (2000 Carnegie-Rochester)
    - It seems we need more than indeterminacy to bring theoretical models in line with evidence.

- But wages can be sticky for other reasons, so we may not need to rest (entirely) on indeterminacy
On the “Empirical Approach”

Preference-based welfare calculations provide useful measures of the distance between alternative consumption allocations:

• Observed allocations before and after a “shock”, e.g., HSV (this paper)
• Observed versus insured allocations, e.g., Attanasio and Davis (1996 JPE)
• Observed allocation versus allocation associated with a particular policy intervention
On the “Empirical Approach”

The Empirical Approach can help to assess:

- Relevance of alternative theories of consumption allocations
- Welfare significance of departures from risk-sharing benchmarks
- **Welfare consequences of driving forces behind changes in observed consumption allocations**
- Potential welfare benefits of policy interventions that improve the sharing of consumption risks
On the “Empirical Approach”

AD (1996 JPE) use the Empirical Approach to assess how closely the data approximate an environment with full insurance against between-group consumption risks.

- They compute welfare distance between allocations with and w/o exposure to between-group consumption risks, constraining all allocations to respect the observed time path of aggregate consumption.
- Theirs is not a before-and-after comparison
- AD-type calculations are informative about size of departures from risk-sharing benchmarks regardless of what forces drove the observed consumption shifts.
On the “Structural Approach”

Q: What are the welfare effects of technological (or other forces) that drove rising inequality?

• The Empirical Approach is not suitable for answering this question when agents make important choices in response to the driving forces.

• HSV deploy a Structural Approach to address this question.

• This approach requires specifying a larger model that encompasses driving forces, opportunity sets and choices, in addition to preferences, and the equilibrium interactions among the agents.
In Praise of HSV Model and Analysis

• HSV develop an equilibrium model of labor supply, education and consumption in an environment with incomplete markets, redistributive taxation and skill-biased technology shifts.

• The model and analysis are impressive in the combination of closed-form solutions and flexible specifications that map to data in rich, useful ways.

• A very nice framework for evaluating the welfare consequences of (some) forces behind rising inequality and for analyzing various consumption smoothing mechanisms.
Some Concerns, 1

• In practice, agents can’t borrow at the risk-free rate. Many (most?) carry positive balances on borrowings at several percentage points above the risk-free rate (see, e.g., Davis, Kubler, and Willen, RESTAT 2006).

• Gruber (JPE 1997) evidence on consumption-smoothing role of UI benefits implies much failure to self insure against transitory shocks.

• These and other observations suggest less scope for consumption smoothing in response to “insurable” shocks than HSV assume.
Some Concerns, 2

- HSV stress that welfare increases in the variance of insurable shock. This effect yields welfare gains from rising variability of transitory (insurable) component of earnings in their analysis.

Three reasons for skepticism about the size of this source of welfare gains:

1. Less insurability than HSV assume
2. Limited ability to quickly adjust hours
3. It’s not clear that the transitory component of idiosyncratic wage variability rose over time.
Turbulence and Earnings Volatility

• The best available evidence for prime-age workers shows a downward drift in the volatility of individual earnings from 1980 to 2005. See Sabelhaus & Song (2010 JME), who examine earnings volatility in a 1 percent sample of social security records.

• Turbulence in the sense of job-loss risk and unemployment incidence also trended downward from the early 1980s to the mid 2000s.
  – Davis (2008 AER P&P) and Davis et al. (2010 AEJ: Macro)
Some Concerns, 3

• HSV attribute the rising skill premium to technology shift that favors skilled workers.
• The technology shift generates welfare gains because agents can, at a cost, exploit the shift to raise productivity, earnings and consumption.

Three concerns in this regard:

1. Focus on SS outcomes overstates welfare gain
2. In fact, many agents cannot exploit the shift by virtue of age, ability or background.
3. Rising skill premium may partly reflect supply-side shifts, e.g., cost of education, backgrounds…