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Ranking of job applicants, on-the-job search, and persistent unemployment

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Abstract

We formulate an efficiency wage model with on-the-job search where wages depend on turnover and employers may use information on whether the searching worker is employed or unemployed as a hiring criterion. We show theoretically that such ranking of job applicants by employment status raises both the level and the persistence of unemployment and numerically that the effects may be substantial. More prevalent ranking in Europe compared to the US (because of more rigid wage structures, etc.) could potentially help to explain the high and persistent unemployment in Europe.

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1. Introduction

When one compares European and US labour markets, several differences are apparent. Unemployment rates are much higher, turnover is much lower, and the adjustment back to equilibrium after a shock is much slower in Europe. While high unemployment may plausibly be blamed on unions and labour market rigidities and low turnover may be due to cultural differences, the last observation is especially intriguing. In several European countries, unemployment has remained high for a long time after it increased due to temporary cyclical shocks—a phenomenon usually called persistence or hysteresis. Adjustment costs and insider–outsider models can explain some persistence, but they can hardly generate the extreme persistence found in the data.

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Generous unemployment benefits may make unemployed workers search less and make them less willing to take the jobs they can get. This can explain high unemployment, but seems less plausible as an explanation of the *persistence* of unemployment. While it is true that unemployment persists if some of those laid off due to a negative shock are slow to return to employment, this effect becomes progressively less important as those who became unemployed at the time of the shock find jobs. So this argument cannot explain a persistence of unemployment that is much larger than the average duration of unemployment for individual workers. Thus, it seems hard to explain a very high persistence of unemployment focusing on the search behaviour of unemployed workers.[1]

Why is unemployment so persistent in Europe? In this paper, we take a new look at this question, emphasizing two aspects of the labour market. The first is the importance of turnover for wage setting. The importance of voluntary turnover is well documented. Holmlund (1984) and Akerlof et al. (1988) report quit rates of around 2% per month for the US, Sweden, and Japan, and Boeri (1999) finds that worker flows from one job to another constitute around 50% of all hiring in several European economies. Pissarides and Wadsworth (1994) report that around 5% of all employed workers in Britain search for a new job, and according to Holmlund (1984), about 8% of employed workers in Sweden engage in job search during a year. Lane et al. (1996) show that worker reallocation is two to three times as great as job reallocation and labour turnover is procyclical because procyclical quits dominate countercyclical layoffs (Anderson and Meyer, 1994). McCormick (1988) shows that total separations depend strongly on the number of available vacancies. Survey evidence shows that firms care about turnover. Concerns about hiring and training costs, and loss of competence due to turnover, deter firms from wage cuts (Blinder and Choi, 1990; Campbell and Kamlani, 1997).

The second starting point is the observation that unemployed workers are sometimes at a disadvantage in the competition for jobs because some employers prefer to hire already employed workers. Blau and Robins (1990) show that in the US, employed job searchers receive almost twice as many job offers as unemployed searchers with the same search effort. Winter-Ebmer (1991) finds that employment status is used as a screening device for productivity in Austria, and Bewley (1999) and Agell and Lundborg (1999) find that a substantial fraction of employers in the US and Sweden view unemployment as a signal of lower productivity.

With search on the job, and costly turnover, the firm's optimal wage should depend on the probability that its employees find other jobs. If it becomes easier to find jobs, firms should raise wages to prevent costly turnover. If, in addition, unemployed workers do not compete for jobs on an equal basis with employed applicants, this makes it easier for employed workers to get the jobs they apply for, so firms should raise wages. In other words, we should expect an *interaction* between turnover, wage setting, and the disadvantage that unemployed workers have in the competition for jobs. More ranking of job applicants should raise wages and make unemployment higher and more persistent.

[1] This argument is made by Pissarides (1992) and Bean (1994). For example, Ljungqvist and Sargent (1998) assume that workers lose on average 40% of their human capital when they become unemployed, and that the replacement ratio is 70%. Still they get a very modest amount of persistence in their model; about 1/8 of the shock remains after 2 years. For a summary of the effects of unemployment insurance, see Holmlund (1998).