Labour Market transitions and Wages: An empirical Analysis

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Starting from the Krugman hypothesis that high unemployment and low wage dispersion are two sides of the same coin, we examine the connection between unemployment and wage dispersion. On theoretical grounds and since the aspect of heterogeneity is often ignored in the literature, we look at this connection for individuals with comparable attributes (cells). From one theoretical point of view we argue that wages are determined by the marginal productivity of the individuals. Differences in the residual wage dispersion are argued to come from different minimum wages set by labour unions. If minimum wages are high, wage dispersion is low and we observe a high unemployment rate. Correspondingly, low wage dispersion implies high entry rates to unemployment and low exit rates out from unemployment. A competing view regards the wages in one cell of observationally equivalent individuals as basically determined by search frictions. From this point of view, wage dispersion is an indicator of a high monopsony power of the firms, stemming from a high amount of search frictions. But when search frictions are high, we observe many transitions from employment to unemployment and only few job-to-job transitions. This implies also a high unemployment rate. In the empirical section we use a big administrative dataset for Germany to examine the theoretical hypothesis. Using a Fixed-effects-GLS-approach, we try to discriminate between the two hypotheses. The results for the transition rates are not convincing for neither theory. A remarkable result is however, that, as predicted by search theory, the unemployment rate in one cell is positively related to the wage dispersion in this cell, which thereby contradicts the Krugman hypothesis.

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