

NEW EVIDENCE ON THE WAGE CURVE

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Abstract

The standard estimator introduced by Blanchflower and Oswald (1994) to determine the short run unemployment elasticity of pay controls for both regional and time period fixed effects. This paper identifies two general cases in which the estimator that controls for regional fixed effects but not for time period fixed effects offers a better estimate of this elasticity: (1) the correlation coefficients of the unemployment rate observed at single regions over time are large and diminish slightly over time, and (2) the national unemployment rate is high.

The standard estimator also takes no account of the spatial relationship among regions. Ignoring this relationship may seriously bias the results. To investigate this, the East German wage curve is estimated including spatial effects using panel data classified into 114 administrative districts over the period 1993-1999. Moreover, we also control for the possibility that the unemployment rate is correlated with the disturbance term.

The short run unemployment elasticity of pay found for Eastern Germany amounts to -0.112, a figure very close to the -0.10 posited by Blanchflower and Oswald, though its foundation is completely different. In contrast to Blanchflower and Oswald, our figure is corrected for spatial effects and also captures the downward effect of the national unemployment rate. Without them, the unemployment elasticity would successively more than double at -0.242 or shrink to -0.006.

KEYWORDS: Wage Curve, Panel Data, Spatial Autocorrelation, Instrumental Variables, Short Run, Long Run, Eastern Germany.

CONCEPT VERSION: 15 APRIL 2002

<http://www.aea.fed-eco.org/fr/archives/2002Bruxelles/programme.asp>