

**“Comments on 'Labor Market Contracts and Inflation' by D.J.B. Mitchell and L.J. Kimball,” in  
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# Workers, Jobs, and Inflation

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in the paper, this is one of the most common sorts of contingency arrangements found in collective bargaining agreements. The simulations of the "wage equation with escalators" in both the four-equation and UCLA models are different from the actual world of escalation. A closer approximation of contractual reality would be to combine the features of an equation with long-term contracts and an equation with escalators. Until such a model is explored, the rather favorable comments that the authors advance on the potential value of widespread escalation for macroeconomic adjustment may be premature. The larger issue that this raises is the endogeneity of contracts and contract issues. This is a relatively unexplored aspect of the recent work on contract theory, but until the endogenous aspects of contracts in labor markets are modeled, it is risky to draw strong policy conclusions from simulation models.

#### Comments by John B. Taylor

The Mitchell-Kimbell paper is divided into two largely distinct parts. I like the first part very much. The critical review of the invisible handshake literature is extremely useful and informative. However, the second part of the paper is rather uninformative with respect to the central issue raised, that is, the relationship between wage contracts and inflation.

To illustrate some of my reservations and why I do not think the simulation experiments are informative, consider equation 5a, which is the wage-change determination equation. Equation 5a is varied in 5b, 5c, and 5d to represent alternative forms of contracts. For example, according to this methodology, if one wants to investigate the effects of longer-term contracts on the inflationary process, the authors suggest varying the coefficient of the lagged wage. Alternatively, if one wants to represent different forms of indexing, the coefficient on the price feedback would be adjusted.

Consider this technique as it applies to adjusting the coefficient on lagged wages. There is no indication given as to how this coefficient would correspond to contract length, or how one would go about matching up a certain set of contractual institutions with the coefficient. Essentially, the numerical value of this coefficient is arbitrary. Moreover, the lagged variables in equation 5 could represent expectations

of inflation as much as they represent previous contract decisions. Hence, simulation of the model with alternative values of this coefficient conveys no direct information about the effect of contracts. The coefficient represents a conglomeration of the expectations and contract effects on inflation inertia.

There are other ways to go about achieving the important objective of finding out the effect of contracts on inflation. In my own recent research I have emphasized two features of the contracting mechanism that I do not think are emphasized here. One is the overlapping of contracts—the simple fact that all contracts in the economy are not signed at the same point in time; the second—an issue alluded to above—is that not only are contracts part of the inertial mechanism of inflation, expectations of inflation also play an important part. In any simulation study, it is necessary at least to discuss how one would go about extracting that expectation component from the contractual component.

In my own research I have assumed as a behavioral idea that the contract wage is set relative to the expected prevailing wage during the contract period. Wage decisions would also be influenced by other variables, such as the unemployment rate emphasized in the Mitchell-Kimbell paper. With this formulation, the coefficients representing expectations emerge rather explicitly, and it is possible to estimate these coefficients using rational expectations or adaptive expectations, whichever one feels is appropriate.

I have worked with simulating models of this kind with fairly realistic parameter values and find, perhaps not surprisingly, that the trade-off between inflation and unemployment is not nearly as pessimistic as is found in the Mitchell and Kimbell simulations. That result largely depends on the expectations being influenced by policy—by a change in the policy regime.

There is one additional way to go about distinguishing between contracts and expectations, or between forward-looking and backward-looking wage-setting behavior. This is to use actual contract data. The Bureau of Labor Statistics has a systematic data file on union contracts, which can be referenced by a computer program. Although the data set is expensive to reference, it could be used to help distinguish between expectations and inertia. The main difficulty with this approach is that many wage contracts are implicit and arise in the nonunion sector. In this respect the BLS data on union contracts is incomplete.