



Bringing Labor Economics to Business

Acceptance speech by

Edward P. Lazear

IZA Prize Laureate 2004

Jack Steele Parker Professor of Human Resources Management and Economics
Graduate School of Business, Stanford University

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Morris A. Cox Senior Fellow
Hoover Institution

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CHECK AGAINST DELIVERY

The overused words that “it is a great honor to receive this prize” are inadequate to describe my feelings of joy, gratitude and pride at having been awarded the IZA prize in Labor Economics. Although this prize has only been given twice before it has already received international recognition. Indeed it is quite a privilege to join my illustrious predecessors who are in large part responsible for the prestige that the IZA prize has already acquired. But part of the reason for the prestige of the prize is that IZA has itself become an extremely prestigious organization during its relatively short existence. So IZA can be proud as well because its efforts have paid off. Not only has IZA furthered science and general scholarship in labor economics, but it has become a model for intellectual institutions around the world.

I have many people to thank. First are the two Klausen. Klaus Zumwinkel, the CEO of Deutsche Post, who had the vision to support an organization like IZA. He was able to see that the activities of IZA would have pay off both in the short and long run to academics, business people, and policy makers. Klaus Zimmerman, a significant scholar in his own right, is certainly one of the most important academic entrepreneurs in our field. Klaus has had a huge impact on economics in general, and on labor economics in particular, not only through his own work but by being able to motivate and organize the work of others. I also owe my thanks to the selection committee, which consists of Klaus Zimmerman, Armin Falk, Richard Portes, Gary Becker and George Akerlof. Personally, perhaps my deepest debt of gratitude goes to my two most important economic role models, people who were mentors to me and examples to follow. They are Gary Becker and Sherwin Rosen. Becker is not just one of the finest economists in the history of this field but more broadly he is one of the greatest social scientists of the 20th century. Sherwin Rosen was my colleague and teacher for almost 30 years. A leading, if not *the* leading labor economist in the world, Sherwin surely would have preceded me were he alive today. I thank Uschi Backes-Gellner for agreeing to introduce me tonight, and more importantly for being my co-author in a book that made labor economics accessible to students in Germany. I am grateful to the Minister of Labor, Wolfgang Clement, for giving his time tonight to add weight and importance to this event. Finally, I thank my family, my wife Vicki who is here tonight and my daughter Julie who unfortunately could not make it. Julie is in Los Angeles taking here first college

midterms right now, and hopefully doing very well on them. Finally, there are many who have supported me professionally by making my work environment a positive one. I have many deans to thank, and maybe most specifically, two of my best friends John Raisian, Director of the Hoover Institution, and Mike Spence, former Dean of the Graduate School of Business at Stanford.

In reading the notification that went along with the award statement I concluded that the award was primarily for my work in personnel economics, although a number of other areas were mentioned as well. But this is a particularly fitting year to recognize personnel economics because IZA has just begun a new program in personnel economics under the direction of Research Director Armin Falk and program directors Bentley McLeod and David Huffman. I believe that this new research initiative promises to be one of IZA's most fertile areas for research. The field of personnel economics has generated a large amount of theoretical work over the past 20 years and more is being created every day. More important though, is that recently new data have come available which make testing the theories possible and allow applications of the theories to be described in much richer detail. Key, also, is that this field is relevant to business and the research has the potential to make a real impact on the way that firms operate. Not much of the research in economics can make the same claim. So I compliment IZA and Klaus and Armin in particular for their insight and willingness to support what I believe is an important area of labor economics.

Uschi has certainly said more about me than I deserve but Klaus Zimmerman asked me to say a few words about my research. Personnel economics is primarily about personnel or human resources policy. It is concerned with the traditional areas that human resources people study, including such topics as choosing the right workers, hiring, training, compensation methods, worker motivation, worker evaluation, and worker empowerment. Personnel economics is different from personnel in that it uses the tools of microeconomics and statistics to deal with these questions in a more scientific manner than the traditional approaches use.

The beauty of personnel economics is that it is economics and economists have the ability to answer questions in a much less ambiguous and more parsimonious fashion than other social sciences. Economics in general and personnel economics is distinguished from other social sciences by two key concepts: rationality and equilibrium. Economics assumes rational maximizing actors. This is true even in the fields of economics that allow for non-traditional behavior. So, for example, Akerlof-style behavioral models might allow for an atypical set of preferences like identity, but the models that are built still use the tools of maximization to generate predictions. Indeed, Armin Falk of IZA and his co-authors are among the finest examples of using tight economic models to obtain predictions in the experimental environment. Models based on rationality provide clean, unambiguous predictions that are testable, refutable, and therefore conform to the scientific method.

Second, economics in general and personnel economics in particular employs the notion of equilibrium. In economics, behavior of the individual actors are aggregated to examine what happens when they interact. Often, this is in the context of a market. The economist's most familiar tools are supply and demand and in labor economics and personnel economics, supply and demand are the fundamental underlying concepts. Other social sciences discuss spillover and feedback effects, but among social scientists, only economists insist on a physical-sciences-style equilibrium as part of the analysis. The discipline of understanding equilibrium is key in personnel economics. Firms cannot impose hardship on workers without bearing a cost and that cost is determined by market competition.

Finally, personnel economics is prescriptive. Because it is a discipline that was developed in a business school context, researchers in personnel economics were not embarrassed to offer normative advice on how best to maximize profits. Alfred Marshall said that it is not the role of economists to inform brewers how to brew beer. But personnel economists are willing to provide such advice. We not only describe when we expect to see certain patterns in the world, but write textbooks teaching business students how to best achieve the desired results.

How did I get into personnel economics? The answer is by accident. Producing good research is, in large part, luck. I remember one over 25 years ago. I was tuned into a news

discussion about mandatory retirement which was soon to become illegal in the United States. I remember thinking that the abolition of mandatory retirement might have dramatic effects on the labor market but then wondered why mandatory retirement existed in the first place. Most people simply took it for granted. But discontinuities such as those that require that a worker leave on his 65th birthday are difficult for economists to explain. I considered all the traditional explanations for mandatory retirement and decided that each was logically flawed. As a young person I looked around and also noticed that many of my senior colleagues who had high earnings were not necessarily producing so much. Their most productive years had occurred when they were younger but the highest wages occurred when they were older. The provision of incentives was at the heart of the matter and high wages for senior workers create an incentive for all to work hard. But high senior worker pay discourages retirement. As a result mandatory retirement was a necessary byproduct of this type of incentives scheme. In 1979 my first paper in personnel economics, “Why is there mandatory retirement?” was published in the *Journal of Political Economy*.

About the same time, Sherwin Rosen and I had been working on the pay of politicians. Being a successful politician was like winning contest so I started thinking about the executive labor market as being like a tournament. On a run one day, I decided I had a way to model this structure of tournaments and over the next two to three weeks scribbled out notes. I remember being very excited. Each day new results came out and they all seemed to make sense. When I returned to Chicago in the Fall, I told Sherwin about the work, and started writing on the blackboard in his office. I could see that Sherwin was much less excited and he quickly told me that the solution to this incentive problem was to pay a piece rate. I immediately realized that Sherwin was correct and went off, dejected. A couple of months later, Sherwin and I started talking again and we realized that there was more to it than that. We discovered that tournaments are an often superior alternative to piece rates and wrote the draft of the tournament paper that eventually became the 1981 *Journal of Political Economy* article.

The other factor that pushed me into personnel economics was that I started teaching business students. Initially, I taught the traditional topics in labor economics including

supply and demand for labor, unions, unemployment and so forth. Much to my chagrin, the MBAs were less than completely thrilled with the material. They found it neither interesting nor useful. It hurt my ego when I saw students sleeping in my class and that forced me to talk about issues that were more relevant to them. Of course mandatory retirement and tournaments were on my mind at the time so I brought those subjects into the classroom and found that the students actually liked the topics. I realized that this was a field that not only had intellectual appeal but also might have business relevance. Throughout my career I have forced myself to try to write papers that were not only academically serious, but also answered questions that people in the business community found interesting.

The academic production function involves relies on the inputs of others. I have already mentioned my two most important role models, Sherwin Rosen and Gary Becker. And I'd like to pass on what I learned from them because I think that their wisdom is so deep that I should not monopolize it.

Sherwin taught me discipline and rigor. But more importantly, Sherwin thought deeply about subjects and revisited them often in his career. Among all the economists I have known, Sherwin is arguably the deepest. I have tried to follow his example, with only mixed success. But I have on many occasions written papers that followed on topics that I had first worked on many years before. I have found this to be a very effective strategy because scholars understand questions at a very different level after they have been floating around in their brains for five to ten years. Sherwin was a master at doing this and it is a model that is worth mimicking.

Gary Becker more than anyone else taught me to reach for the stars. It is impossible to know Gary or even to read his work without realizing that he is a man who has never been afraid to be creative. Gary has used his tools to consider questions far outside the realm of traditional economics. A few years back, I was asked to write a paper on the extension of economics to other areas for the Millennium Issue of the *Quarterly Journal of Economics*. I wrote a paper called "Economic Imperialism" which discusses how economics has been successful in moving into and informing other areas of social science and the law. Gary is featured

prominently in that essay, and there are many others as well. Watching Gary work gave me the confidence to extend the tools that I use to other areas, some of which are also considered outside the realm of economics. Most recently, I have studied culture and assimilation and have returned to the economics of education.

I have taken some intellectual risks in my career and today you have rewarded me for some investments that have paid off. But I have also had my share of bankruptcies. Hopefully you don't remember them, and there are some that I don't remember at all. Last year, I returned to speak at the University of Chicago. After my seminar, a student came up to me and asked me about a paper that I had written many years earlier saying that he was doing some work on the topic and wanted to talk to me about it. I told him that he must be mistaken. I hadn't written a paper on that topic. He insisted that I had. After about two minutes of my denial, he pulled the paper out and showed it to me. It was a paper that I had published in a reasonably well known journal about 25 years earlier. But it was so terrible that I had just erased it from my memory. My advice to the student was that he ought to think about working on another topic.

Like all the academics in this room, I have tried to produce good research and to serve my students well in the classroom. But I also recognize that at least fifty percent of success in any field, academics or other, is based on luck. I am genuinely happy that I was lucky enough to work in an area that IZA felt worthy of the Prize. Thank you again for this great honor.