Models of Wage Inequality in Labor Economics

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Introduction

The General topic here is Socioeconomic Inequality

From my perspective

- most socioeconomic inequality comes from income inequality
- most income inequality comes from earnings inequality
- the most important determinant of earnings inequality is wage inequality

Thus anyone interested in Socioeconomic Inequality should think about wage inequality

In these lectures I want to present a broad overview of the basic models that labor economists use to think about wage inequality (Haveman will spend more time on data later)

Wage Inequality

In an undergraduate economics class labor is one factor of production.

The price paid to that factor is the wage.

How do we change this to get wage inequality?

Sources of Earnings Inequality

People may make different amounts of money because:

- They have different skills
  - The Roy model
  - Human Capital
- They make different choices
  - Compensating differentials
- The market treats similar people differently
  - Labor market discrimination
  - Other labor market imperfections

The Roy Model

In the basic model people have two jobs, hunting and fishing

You get paid based on the number of fish or rabbits you catch

You can get skewness in distribution if one job is “harder” than the other

Human Capital

But where do these skill differences come from?

While some might be “Nature” certainly a lot of it is “Nurture"

We think of this as human capital. Many important sources:

- Schooling
- Family Environment (time and money)
- Neighborhoods
- Formal investments prior to school
- Learning skills after labor market entry

Also many types of human capital

- Cognitive skills
- Interpersonal skills
- Other non-cognitive skills
- Health
- More specific Job skills

Compensating Differentials

(or equalizing differences)

In the Roy model people only care about income, but differed in skills

In the simplest version of this model some people want to be stock brokers others want to be teachers

This is one source of inequality

Presumably not an important determinant of poverty

Discrimination

In this context I want to think of this as people with the same skill levels being paid different wages

In economics really four types:

- Employer Discrimination
- Consumer Discrimination
- Co-worker Discrimination
- Classical Statistical Discrimination
- Statistical Discrimination with Incorrect Beliefs

Labor Market Imperfections

Markets do not work perfectly.

Potential imperfections:

- mobility/search/coordination frictions
- monopsony power by firms/unionization by workers
- efficiency wages