

Microfoundations of Rising Experience Premia

Theodore Koutmeridis
University of Warwick, England

During the past three decades both the skill and the experience premium increased significantly in English-speaking countries, leading to higher wage inequality. The skill premium seems to increase within any experience group. On the contrary, the experience premium rises considerably within the group of unskilled workers, while it remains flat among the skilled ones. Existing theoretical literature fails to provide a unified explanation of these facts. Using a model of asymmetric information, credit market imperfections and employer learning, I propose a microfounded justification for these recent patterns of wage inequality. I show that the relaxation of credit constraints decreased the minimum wage and this generated an increase in the experience premium within the group of unskilled workers. This suggests a mirror image between real minimum wages and economic inequality, a pattern that finds strong empirical support in many countries and especially in US, UK and Canada. This theory is also consistent with a rising skill premium within both the group of experienced and inexperienced workers.

According to Hornstein, Krussel and Violante (2005) one of the most important challenges to the hypothesis that the recent changes in the wage structure are linked to technological progress, is to explain the combination of the rise in the returns to labor market experience for the low-educated workers and the flat pattern of the experience premium for college graduates. They highlight that the existing theoretical literature does not provide an answer to the experience premium puzzle. This study attempts to fill this gap in the literature by providing a microfounded explanation for the rising experience premium and ultimately for widening wage inequality.

Recent empirical evidence supports that wage inequality measured by the experience and the skill premium increased sharply since the 1980s (see Krueger, Perri, Pistaferri and Violante (2010)). During the same period credit constraints relaxed significantly, generating more equal opportunities. This tendency has been observed in many developed countries and especially in Anglo-Saxon countries. Within the vast literature on the sources of labor market inequalities, most papers emphasize on the amplification of the skill premium and attribute this new pattern of wage inequality on the skill-biased technical change (SBTC). However, the increase of the experience premium still remains an understudied aspect of rising wage inequality. According to Card and DiNardo (2002), the evidence linking growing wage inequality to SBTC is surprisingly weak. They suggest that the SBTC might have been responsible for expanding wage inequality during the 1970s; however, from early 1980s onwards other plausible factors, such as the fall of real minimum wage, might have attributed to this pattern of increasing wage inequality. Furthermore, Weinberg (2004) finds that the profile of the experience premium for the US is increasing for high school graduates and flat for college graduates.

Based on the existing literature, I summarize the following recent evidence for the evolution of wage inequality:

FACT 1: The experience premium increased significantly in almost all countries.

FACT 2: The experience premium increased primarily within the group of high school graduates, while it has remained constant for college graduates.

FACT 3: The skill premium increased significantly in Anglo-Saxon countries while it declined in continental European countries.

FACT 4: Across time there is a systematic negative relationship between real minimum wages and the experience premium within the group of high school graduates, generating variations to overall wage inequality.

The contribution of this paper is the revelation of a new theoretical channel between credit market imperfections and the experience premium. In particular, I find that when credit constraints relax, minimum wages decrease for the unskilled and inexperienced workers, generating primarily an increase to the experience premium within the group of unskilled workers but also a rise to the skill premium. This theoretical result finds strong empirical support for the English-speaking countries and has some interesting policy implications.

The economic intuition behind the most important results of this paper, is that without knowing the productivity of each person, competitive firms form beliefs for their potential employees and pay them according to their expected productivity. Thirty years ago, it was more likely for the unskilled worker to be highly productive, since credit constraints were more severe and educational opportunities fewer. However, credit frictions relaxed significantly since then, and so, educational opportunities increased. That is why being unskilled today is perceived by firms as a very bad signal for workers ability. This is the reason why, some decades ago, firms used to offer higher initial wages to the unskilled-inexperienced workers. Nowadays initial real wages for unskilled-inexperienced labor are much lower; however, today if an unskilled employee proves that he is highly productive but he just happened to be one of the few credit constrained workers, he gets a much higher return with experience, comparing to what he would get during the 1970s. This is the underlying mechanism that boosted the experience premium over the past three decades. In the same spirit, the gap between the average skilled and the average unskilled wage has also widened, in response to the fall on the initial wage for the unskilled worker.

An interesting policy implication is that offering more opportunities might generate greater inequality, since people are born different in many aspects, including ability. Thus, policy makers must distinguish equality of opportunity from substantial economic equality since policies favouring the one might harm the other.

Concluding, my results are based on three crucial and realistic elements of the labor market: asymmetric information, credit constraints and asymmetric employer learning. Although the model builds on a pure signaling approach its results are robust even after augmenting it with human capital and/or learning-by-doing. This paper provides a robust microfounded game-theoretical reasoning for significant macroeconomic facts, such as the rise in wage inequality. I feel that my labor supply approach must be seen as complementary to the SBTC view that focuses on labor demand. Unambiguously, this paper does not complete but just initiates an inquiry for the revelation of the laws that determine the evolution of the experience premium and ultimately of labor income distribution.