

Do skills matter for wage inequality?

Policies to tackle wage inequality should focus on skills alongside reform of labor market institutions

Keywords: skills, wage inequality, labor market institutions

ELEVATOR PITCH

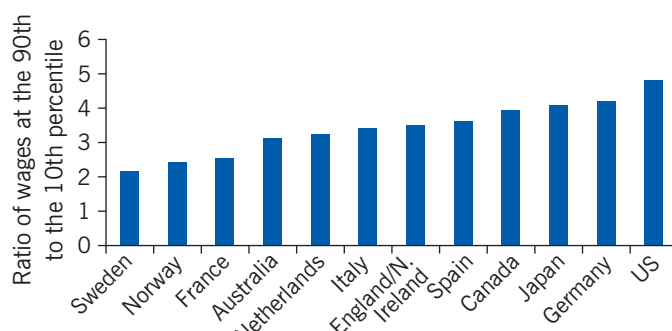
Policymakers in many OECD countries are increasingly concerned about high and rising inequality. Much of the evidence (as far back as Adam Smith's *The Wealth of Nations*) points to the importance of skills in tackling wage inequality. Yet a recent strand of the research argues that (cognitive) skills explain little of the cross-country differences in wage inequality. Does this challenge the received wisdom on the relationship between skills and wage inequality? No, because this recent research fails to account for the fact that the price of skill (and thus wage inequality) is determined to a large extent by the match of skill supply and demand.

KEY FINDINGS

Pros

- + Skills matter for wages at the individual level: skilled workers have, on average, higher wages than unskilled workers.
- + Differences in skills can explain a significant share of the wage gap between certain socio-economic groups.
- + Changes in the demand for skills, driven by technological change, globalization, population aging, and organizational changes, have increased the return to skill and, thereby, wage inequality.
- + Wage inequality tends to be lower in countries that are better at meeting the demand for skills.

Wage inequality is much higher in some countries than in others



Source: Author's calculations based on the 2012 Survey of Adult Skills, Program for the International Assessment of Adult Competencies. Online at: <http://www.oecd.org/site/piaac/publicdataandanalysis.htm>

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Cons

- Differences in skills and in their distribution account for only a small fraction of differences in wage inequality between countries.
- Differences in the prices of skills (or how skills are rewarded) account for a much larger proportion of cross-country differences in wage inequality.
- The prices of skills are determined, at least in part, by labor market institutions, which have an important impact on the distribution of wages.
- A large portion of cross-country differences in wage inequality remains unexplained by skills or skill prices.

AUTHOR'S MAIN MESSAGE

While cross-country differences in skills and their distribution explain only a small part of international differences in wage inequality, it is wrong to conclude that skills do not matter for wage inequality. Differences in wage inequality across countries are driven primarily by differences in the return to skills, which is determined in part by labor market institutions, but also by how well the supply of skills meets the demand. A comprehensive policy package to tackle wage inequality should include a focus on skills, reforms of labor market institutions that influence how skills are rewarded, and alignment of skill supply and demand.