

Income Processes, Search, Incomplete markets: Skills versus Luck?

Second course in the (search & matching oriented) Macro-Labor Economics sequence

The aim of this course is to document the sources of income inequality that households face over their lifetime and the uncertainty associated with income processes, and to understand their effects on households' decisions and well-being. For example, these sources influence household savings and consumption decisions: we will study how the income process affects these decisions (qualitatively and quantitatively) in economic models. In the first part of the course, we discuss the empirical facts, and highlight the standard complete and incomplete market approaches to income heterogeneity and income uncertainty.

In the second part of the course, we focus in more detail on the role of search frictions in creating diverging income histories for inherently identical worker or households.

Search theory studies the implications of departing from the competitive markets setup along an important dimension: it incorporates that it's a costly and time-consuming process to find the best possible match with the other side in the labor market. When workers looking for a job or firms with vacancies are in the labor market, they do not possess all information needed to determine which firm/worker is the best possible match among all available matches and how to contact this firm/worker. Instead of forming a relationship with only the best possible partner, who might never appear on the radar, it's optimal to form relationships with those agents that are deemed 'good enough'. This has numerous implications, a number of which are investigated in the first course in this sequence, and a further number of interesting implications is studied in this course.

In the second part of the course in particular, we look at the heterogeneity in labor markets in general, and in addition ask how big the role of search frictions are, quantitatively, in creating heterogeneity, as opposed to e.g. fundamental differences in worker productivity. In particular, we use search theory in an attempt to infer how large the role of 'luck' is; look at whether endogenous labor supply choices can offset some of the impact of search frictions, the endogenous savings decisions given search frictions, and the interaction of search frictions with the other sources of income inequality in *equilibrium* in the labor market.

As said, this course is the second in the (macro-) labor economics sequence and can be taken independently from the first course, although it is strongly encouraged to take both.

Evaluation

A number of homeworks, a presentation of a paper related to the course (selected from a list), and a self-authored paper proposal

Books

There are a number of books that help you study and understand the models covered in the course, while also discussing the empirical regularities on the labor market, and their relation to the theory. It is strongly recommended to have these books at your finger tips during the course (and after, if you continue in this line of research)

Pissarides, Chris (2000), *Equilibrium Unemployment*, MIT Press

Manning, Alan (2003) *Monopsony in Motion*, Princeton University Press

Cahuc, Pierre and Andre Zylberberg (2004) Labor Economics, MIT Press

Additional reading:

Mortensen, Dale (2003) Wage Dispersion, MIT Press

Outline

GENERAL INTRODUCTION a review of search theory, and a life-cycle paper (2 lectures) .

Pissarides, Chris (2000) Equilibrium Unemployment, chapter 1

Burdett, Kenneth and Dale Mortensen (1998) “Wage Differentials, Employer Size, and Unemployment”, International Economic Review, 39(2)

Moen, Espen (1997) “Competitive Search Equilibrium”, JPE

Menzio, Guido and Shouyong Shi (2010) Efficient Search on-the-job over the Business Cycle

Menzio, Guido, Irina Telyukova and Ludo Visschers (2010) Directed search over the life cycle

PART 1: INCOME OVER THE LIFE-CYCLE, INCOME HETEROGENEITY AND INCOME UNCERTAINTY

Empirics (3 lectures)

1) income over the life cycle: human capital, match capital, learning.

Rubinstein, Yoni, and Yoram Weiss (2006). “Post School Earnings: Search versus Human Capital”, Chapter One, in Handbook on the Economics of Education, eds., Eric Hanushek and Finis Welch.

Ben-Porath, Y (1967) “The production of human capital and the life cycle of earnings”, Journal of Political Economy, 75, pp. 352-365

2) income heterogeneity (short)

Autor, David, Lawrence Katz, and Melissa Kearney (2007). Trends in U.S. Wage Inequality: Revising the Revisionists, mimeo, Harvard University

Eckstein, Zvi and Eva Nagypal (2004). U.S. Earnings Inequality 1961-2002. Minneapolis Fed QR.

Piketty Thomas and Emmanuel Saez (2003). Income Inequality in the U.S. (1913-1998).
Quarterly Journal of Economics

3) income uncertainty (more extensive)

Blundell, Richard and Ian Preston (1998). Consumption Inequality and Income Uncertainty.
Quarterly Journal of Economic

Gottschalk, Peter and Robert Moffitt (1994). The Growth of Earnings Instability in the U.S.
Labour Market. Brookings Papers of Economic Activity

Low, Hamish; Costas Meghir and Luigi Pistaferri (2010) “Wage risk and employment risk over
the life-cycle”, American Economic Review (forthcoming).

Theory: complete and incomplete markets models

1) Theory: basics

Theory: Complete Markets Models: Sargent and Ljungqvist, Second Edition

Theory: Bewley models: Sargent and Ljungqvist, Second Edition

2) theory and empirics: questions?

--Can complete or incomplete market models explain consumption patterns?

Dirk Krueger's Consumption Theory notes.

Meghir, Costas and Luigi Pistaferri (forthcoming) “Earnings, consumption and lifecycle
choices”, Handbook of Labor Economics

Storesletten, Kjetil, Chris Telmer and Amir Yaron (2001). How Important are Idiosyncratic
Shocks? Evidence from Labor Supply, American Economic Review PP

Huggett, Mark and Alejandro Badel (2007). Interpreting Life-Cycle Inequality Patterns as an
Efficient Allocation: Mission Impossible?, mimeoGeorgetown University

Storesletten, Kjetil, Chris Telmer and Amir Yaron (2004). Consumption and Risk Sharing Over
the Lifecycle. Journal of Monetary Economics

3) Human Capital uncertainty

Guvenen, Fatih (2007). Learning Your Earning: Are Labor Income Shocks Really Very
Persistent?, American Economic Review

PART 2: SEARCH AND INCOME HETEROGENEITY AND INCOME UNCERTAINTY

Search frictions as a significant source of inequality: a negative answer?

Bender, Stefan and Till von Wachter (2007) "In the Right Place at the Wrong Time: The Role of Firms and Luck in Young Workers' Careers", AER

Andrew Heisz; Oreopoulos, Philip and Till von Wachter, "Permanent and Transitory Effects from Graduating in a Recession"

Hornstein, Krusell and Violante (2009): Frictional Wage Dispersion in Search Models: A Quantitative Assessment

Burdett, Coles and Carrillo-Tudela (2010): Human Capital Accumulation and Labour Market Equilibrium, forthcoming IER

Menzio, Guido, Irina Telyukova, and Ludo Visschers (2010): Directed Search over the Lifecycle

Hagedorn, Marcus and Iourii Manovskii (2010) "Search Frictions and Wage Dispersion", Univ. of Pennsylvania working paper, <http://www.econ.upenn.edu/~manovski/research.html>

Bagger, Jesper, Francois Fontaine, Fabien Postel-Vinay and Jean-Marc Robin (2007) "A Tractable Equilibrium Search Model of Individual Wage Dynamics with Experience Accumulation, working paper, Royal Holloway London.

Postel-Vinay, Fabien and Helene Turon (2010) "On-the-job Search, Productivity Shocks, and the Individual Earnings Process", International Economic Review 51(3), 599-629

The role of search frictions and endogenous labor market response:

Krusell, Per; Mukoyama, Toshihiko; Rogerson, Richard and Aysegul Sahin, 2009. "A Three State Model of Worker Flows in General Equilibrium," NBER 15251

Krusell, Per; Mukoyama, Toshihiko; Rogerson, Richard and Aysegul Sahin, Aysegul, 2009. "Aggregate Labor Market Outcomes: The Role of Choice and Chance," NBER 15252

Per Krusell; Toshihiko Mukoyama; Richard Rogerson and Aysegul Sahin, 2008. "Aggregate Implications of Indivisible Labor, Incomplete Markets, and Labor Market Frictions, JME

Per Krusell; Toshihiko Mukoyama and Aysegul Sahin, 2007. "Labor-Market Matching with Precautionary Savings and Aggregate Fluctuations," NBER 15282

Consumption/Saving and Search Frictions

Jeremy Lise (2007) "On-the-Job Search and Precautionary Savings: Theory and Empirics of Earnings and Wealth Inequality"

Website of the course

<https://sites.google.com/site/macrolaborsearch/>