Cross-country Comparison of the Inequality in Earnings and Labor Force Status of Prime Age Men in France, the UK, and the US

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Abstract

In this paper we analyze the cross-country differences in the inequality in earnings and labor force status of prime age men in France, the UK, and the US. We focus in particular on the low-skilled, i.e. individuals, who are at the bottom of the wage distribution. In the UK and the US, where the distribution of wages is more dispersed at both ends, the inactivity rate (sometimes called the not-in-labor force rate) among low-skilled men exceeds the percentage of the unemployed, whereas in France the opposite is true. This leaves the overall joblessness rate among the low-skilled in France similar to that in the US, and that in the UK about one third higher.

We propose a supply side explanation of the observed differences. An employed individual’s decision whether to work or leave the labor force (be inactive) is affected by his wage. A jobless individual’s decision whether to be unemployed and search for a job or be out of labor force is affected by his potential wage. In the UK and the US, where wages are flexible, skill-biased change in labor demand that took place in all three countries, has had a negative effect on the wage of the low-skilled at the bottom of the wage distribution. With lower returns from employment, the low-skilled in the UK and the US are more likely to be inactive. The inactivity rate of the low-skilled is therefore higher in countries with lower relative wages at the bottom of the wage distribution due to the effect of wage on the labor force participation. In France, on the other hand, where wages are rigid, skill-biased changes in labor demand increased unemployment.

We consider all three labor force states (employment, unemployment, and inactivity) and analyze how the probability of being in each one of them varies with wage. A joint analysis of earnings and labor force status allows us to document the employment prospects at different levels of earning capacity, and thus to complement the numerous international-comparison studies of wage inequality with a job security dimension. As we look at the two distributions jointly, we provide evidence on inequality in both the earnings and the employment status of individuals at the same time. We are therefore able to compare the three countries using a broader notion of economic inequality than only income.

We formulate a four-step econometric procedure to estimate the effect of wage on the probability of being employed, the probability of being unemployed, and the probability of being inactive, and explore the relationship between the wage and the respective probabilities. We use data from the Luxembourg Income Study for France, the UK, and the US in selected years from the period 1994-2001. To ensure that the results are not affected by cultural differences in female labor force participation across the three countries, we limit our study to men. We further narrow the population of interest to prime age men (25 and 54 year old) in order to rule out the effect of cross-country
differences as regards institutions that determine the beginning and the end of the labor market career, that is, the educational and the retirement systems. In addition, prime age men represent a population subgroup of individuals who are relatively homogenous across the three countries and who are typically in the labor force. The estimation is carried out for each country separately. Further, we divide the US sample of prime age men by their ethnicity to whites and non-whites.

The two key issues we are interested in are the following: First, is there a negative effect of wage on labor force withdrawal? In particular, can the low relative wages at the bottom of the wage distributions in the UK and the US explain the high inactivity rates among low-skilled prime age men in these two countries? Second, how do the probabilities of being unemployed, and employed, change with different wage levels? In particular, is the unemployment in France concentrated among people with the lowest earning capacity, whose potential wage offers are (as often argued) kept at an inadequately high level by labor market institutions such as high minimum wage or collective bargaining?

We find a significant negative effect of the wage on the probability of being inactive for the UK and the US but none for France. The magnitude of this effect at the wage level corresponding to 25th percentile of the distribution of the potential wages of all prime age men (based on the wages predicted by the model) is substantial in the UK and moderate in the US: an increase of the wage by 1 percent reduces the probability of being inactive by about 0.2 percentage points in the UK, and by 0.08 and 0.07 percentage points among the US whites and the US non-whites respectively.

The effect of the wage on the probability of being unemployed is the biggest in the UK, followed by the US non-whites. The effect at the 10th percentile of the potential wages is similar for the US whites and for France. The curve of the probability of being unemployed is overall steeper in the UK and the US than in France, suggesting that there is greater inequality in the two countries not only in earnings but also in the probability of being unemployed. It is the individuals at the very bottom of the wage distribution in the UK and the US that face a substantially higher probability of being unemployed than the rest of prime age men in the population. On the other hand, low-skilled in France face a relatively similar risk of unemployment irrespective of their earning capacity. The probability of being unemployed of a single forty-year-old man whose earning capacity is at the level of the official minimum wage in the three countries is almost twice as high in the UK or the US than in France. The overall wage elasticity of the three probabilities is highest in the UK and lowest in France.

We conclude that the high inactivity rate among low-skilled prime age men in the UK and the US are to at least some extent driven by the low relative earnings of the low-skilled in the two countries. At the same time, the probability of being unemployed is distributed
more unequally across the different levels of earning capacity in the UK and the US than in France, suggesting that the UK and the US have not only greater earnings inequality, but also a greater inequality in the labor force status, and, in particular, unemployment. These findings provide evidence against the commonly used argument that wage flexibility improves the employment prospects of individuals at the bottom of the wage distribution.

The results also suggest that, in addition to the well-documented wage inequality, the employment prospects and the risk of unemployment are also distributed more unequally in the UK and the US than in France: the people at the bottom of the wage distribution are paid relatively less and have a relatively higher probability of being jobless.

JEL classification: C25, J21, J31, J64

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References


