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Empirical labor search models: A survey

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IFAU – INSTITUTE FOR
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EVALUATION

Empirical labor search models: A survey

Zvi Eckstein
Gerard J van den Berg

WORKING PAPER 2003:18

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Empirical Labor Search Models: A Survey

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September 17, 2003

Abstract

This paper surveys the existing empirical research that uses search theory to empirically analyze labor supply questions in a structural framework, using data on individual labor market transitions and durations, wages, and individual characteristics. The starting points of the literature are the Mincerian earnings function, Heckman's classic selection model, and dynamic optimization theory. We develop a general framework for the labor market where the search for a job involves dynamic decision making under uncertainty. It can be specialized to be in agreement with most published research using labor search models. We discuss estimation, policy evaluation with the estimated model, equilibrium model versions, and the decomposition of wage variation into factors due to heterogeneity of various model determinants as well as search frictions themselves. We summarize the main empirical conclusions.

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1 Introduction

This paper surveys the existing empirical research that uses search theory to empirically analyze labor supply questions in a structural framework, using data on individual labor market transitions and durations, wages, and individual characteristics. This literature has analyzed variety of issues, such as the return to schooling, the interpretation of race earnings differentials, the duration of unemployment and the wage dispersion for homogeneous workers, the effect of the minimum wage, aggregate labor market unemployment and earnings inequality.

The literature, which started off in the early 1980s, builds on the estimation of Mincerian earnings functions, Heckman's classic selection model, and dynamic optimization theory. Earnings functions express earnings in terms of variables like work experience, which may be determined simultaneously with earnings, so that they are potentially endogenous. The classic Heckman selection model provides a framework to handle this endogeneity problem in a static (or long run) setting.¹ Dynamic optimization theory provides a unified framework to simultaneously explain short term and long run outcomes of earnings, wages, and time out of work. Search theory in particular is useful for this purpose. It builds on the principle that it takes time to discover acceptable trading opportunities in the labor market.²

A second motivation for the literature concerns the persistently high unemployment levels in Europe and elsewhere. Traditional neoclassical labor market models are unable to explain long spells of possibly involuntary unemployment. Search models have proven to be fruitful tools for the understanding of unemployment durations and the effectiveness of labor market policies aimed at bringing the unemployed back to work (see e.g. the survey by Mortensen and Pissarides, 1999).

Search theory postulates that certain events (like wage offers) occur randomly from the point of view of the individual. This generates probability distributions for observed labor market outcomes like unemployment and job durations and wages. Data on individual labor market outcomes can then be used to estimate the structural parameters of search models. This solves the dynamic selection effects. What is more, with structural inference, the model that is estimated is formally consistent with the underlying economic "story", because one estimates the determinants of the agents' decision problems. Structural empirical inference also enables a formal test of the adequacy of the theory, and it allows for a careful assessment of the effects of policy changes that is not subject to the Lucas critique.

¹Rosenzweig and Wolpin (2000) make the point that since all the variables in the Mincerian equation are endogenous one cannot hope that there are enough instruments to control for all the selection bias.

²The imperfect information that is involved is usually denoted by the phrase "search frictions".

Contrary to many popular evaluation methods, it allows for an evaluation of counterfactual policies, that is, policies that have not been implemented in reality.

In this paper, we start with a general framework for the labor market where the search for a job is a random sequential process. Following the search literature we show how the general model can be specialized to be in agreement with most published research using labor search models. Specifically, we show how this framework can be restricted to include the following theoretical models: the standard “classical” search model of Mortensen and Lippman and McCall; the search-matching-bargaining model of Diamond and Maskin (1979), Mortensen (1982) and Pissarides (1979); and the wage-posting equilibrium search models popularized by, notably, Albrecht and Axell (1984) and Burdett and Mortensen (1998). For all these models we present the basic properties of the (equilibrium) solution and we explain how one can derive from the model the joint distribution of observations on unemployment durations, accepted wages, etc.. We then present the likelihood function of the model parameters based on standard panel data of individuals, and we discuss identification and estimation of the parameters of these models.

The search strategy of the firm and the worker and the equilibrium wage determination process vary greatly across different models, due to differences in the assumptions made in these models. Yet, all these models generate a dynamic selection process of work that has important implications on the way we empirically interpret labor market data of unemployment and employment durations and observed wages of workers. The survey makes the following main points:

1. All the models have the same common basic structure. The only real difference between the models concerns the equilibrium concept and the wage strategies that workers and firms are assumed to be using. The equilibrium concepts can not be justified by the nature of the economic environment but are either taken as given or based on assumptions concerning information and strategies.

2. With only data on unemployment durations, wages and individual characteristics, the joint likelihood function of the parameters of the model has a common format with common identification and estimation problems.

3. Several important economic implications have been derived from the applications regarding labor supply and individual behavior. First, the results allow for various informative decompositions of individual labor market outcomes. Wage variation can be decomposed into separate effects of individual heterogeneity, firm heterogeneity, and search frictions. The exit rate out of unemployment and the mean unemployment duration can be decomposed into choice (voluntary) and chance (involuntary) components. Secondly, the results enable the quantitative evaluation of labor market policies that affect worker and

firm behavior, like unemployment compensation (insurance), minimum wages, and taxes.

4. The main advantage of the analysis of equilibrium models is that it enables us to measure the implications of the inefficiency due to the market structure with imperfect information.

During the past decades, some surveys have been published on related topics. Eckstein and Wolpin (1989a) examine the specification and structural estimation of dynamic discrete choice models, paying special attention to computational issues. Wolpin (1995) describes the structural estimation of partial job search models. Rogerson and Wright (2001) present a lucid introductory account of job search theory. Mortensen and Pissarides (1999) survey recent developments in the theoretical analysis of equilibrium search and matching models. Van den Berg (1999) surveys the literature on the empirical analysis of equilibrium search models. See Lancaster (1990) and Van den Berg (2001) for overviews of reduced-form duration analysis. In comparison, we focus on the common theoretical and empirical structure and the actual results.

The outline of the survey is as follows. In Section 2 we present the general model framework. In Sections 3, 4, 5, and 6, this is specialized to, respectively, classical job search models, on-the-job search models, equilibrium matching/bargaining models, and equilibrium search models with wage posting and heterogeneous agents. Section 7 concludes.

Sections 3–6 have a common structure: after a presentation of the theoretical framework, we discuss the empirical implementation and estimation strategies, and we subsequently pay attention to the main empirical and policy findings in the corresponding literature. It should be emphasized that the dichotomy between theory and empirics (and the suggested dominance of theory over empirics) becomes less and less accurate the closer we get to the present state of affairs. Up to Flinn and Heckman (1982) in case of partial models, and Eckstein and Wolpin (1989) in case of equilibrium models, empirical work used models taken directly from the theoretical literature.³ Flinn and Heckman (1982), Eckstein and Wolpin (1989) and the subsequent literature have adjusted theoretical models to account for empirical regularities in the data used to estimate their models. In fact, current theoretical developments are driven to a substantial extent by the need to explain regularities found in the empirical literature. In particular, many equilibrium search models with heterogeneity have been developed in response to the empirical studies that were unable to explain important findings with homogeneous models.

³The so-called Phelps Volume (Phelps et al., 1970) is widely seen as marking the onset of the widespread use of search theory. It should be noted that as far back as 1962, Karlin (1962) analyzed a search model for asset trade with discounting that is very similar to the standard sequential job search model.

2 A General Framework

We specify a model that is much more general than any existing search model. The main reason is to show that a wide range of theoretical and empirical research in labor economics has a common basic structure. The model therefore also allows us to make a connection between different sorts of results. By specializing the general model, it can be tailored for specific empirical research. In addition, the general framework reveals the limitations of the existing models, and it provides directions for future work.

Production⁴

Each worker is assumed to provide either zero or one unit of labor. In general, let p_{ij} be the per period unit of labor output by a worker i in firm j . We assume that $p_{ij} = p(x_i, z_j)$ where x_i is a vector of the worker i labor skills (e.g., education and experience) and z_j is a vector of the firm j production skills (e.g., capital stock and production efficiency). Output of firm j is denoted by y_j and is given by,

$$y_j = \sum_{i=1}^I p(x_i, z_j) l_{ij}$$

where I indicates the number of types of workers and l_{ij} denotes the number of workers of type i at firm j .⁵ The workers are ordered such that for all j , $p_{Ij} > p_{I-1j} > \dots > p_{1j}$.

In Section 4 we further generalize this production technology, by allowing for a match-specific component that may have a non-degenerate distribution for given i, j .

Offer Arrival (Matching)

Unemployed and employed workers of type i sample job offers from firm j sequentially, at the Poisson rates λ_i^u and λ_i^e while unemployed and employed, respectively. These Poisson rates vary over i (or, equivalently, over x_i) and can in general be thought to depend on the distribution of firms, on search efforts made by unemployed and employed workers and firms, and on the magnitude and composition of aggregate unemployment U and the aggregate amount of vacancies V in the market.

⁴We avoid explicit definitions that separate between discrete and continuous cases, while we actually specify continuous time models.

⁵The simple additive linear production function is used in most search equilibrium models.

Workers

There is a measure M_i of workers of type i , who face a mortality rate η . Each period there are ηM_i newborn workers. Layoffs occur at a rate δ . When a worker of type i with skills x_i is unemployed s/he receives a flow of leisure and, possibly, unemployment benefits. In addition, there is a flow cost of search effort s_i^l .⁶ The sum of these two flows is equal to the worker utility flow in unemployment, which we denote by u_{it}^u . This notation highlights that all elements in this sum may change over time. When a worker of type i with skills x_i is employed s/he receives a flow of earnings of w_{it} . This, minus the flow cost of search effort, equals the instantaneous utility in the state of employment $u_{it}^e(w_{it})$. Let $d_{it} = 1$ if the individual is working and $d_{it} = 0$ if the individual is unemployed. The worker aims to maximize the expected lifetime utility. At $t = 0$, in the state of unemployment, this present value can be expressed as

$$V_0^u = E\left[\int_0^{\infty} e^{-(\mu+\rho)t} (u_{it}^e(w_{it})d_{it} + u_{it}^u(1 - d_{it}))dt \mid \Omega_0\right] \quad (1)$$

where the expectations are taken over all the random variables in the model, Ω_0 is the information available to the worker at time $t = 0$, and ρ is the discount rate. In some models workers are assumed to be price takers and in others they bargain over the wage with firms.

Firms

The profit flow of firm j is given by,

$$\pi_j = \sum_{i=1}^I (p(x_i, z_j) - w_{ij})l_{ij}(w_{ij})$$

where w_{ij} is the wage that firm j pays to worker i , and where we highlight the dependence of l_{ij} on this wage. We assume that w_{ij} is constant over time. Firms are assumed to maximize the expected present value of profits. However, the firms' set of admissible strategies differs across the models that we survey below.

⁶In many models in the literature, search costs and search effort are optimally determined by equating the marginal costs and benefits of effort. See e.g. Mortensen (1986).

Equilibrium Wages

Three main equilibrium approaches are used in the literature. The first assumes that the wage offer distribution equals the distribution of the worker's marginal (average) productivity, that is $p(x_i, z_j) = w_{ij}$. This formulation follows Lucas and Prescott (1974) where the wage offer distribution is equal to productivity that is different across locations ("islands") populated by different firms.⁷ One may call this a "competitive equilibrium" since profits are zero. With exogenous productivities, the wage offer distribution in this approach is effectively exogenous. Now, consider partial job search models. These by definition have an exogenous wage offer distribution. Such models can be given an equilibrium interpretation by thinking of wages as being equal to productivities. Along these lines, existing empirical analysis with partial models can be justified as equilibrium analyses.

However, firms can typically improve on their profits by offering a lower wage than the marginal product. To see this, note that firms have monopsony power precisely due to the presence of search frictions. For a worker matched to a firm, it takes time, effort, and, ultimately, money to find an alternative match. Because of this, a match may carry a positive rent or surplus. If a match is dissolved then such a surplus evaporates. Agreeing to form a match involves agreeing on how to divide the surplus over the two parties. The firm's part of the surplus can be taken by paying a wage below the marginal product. In sum, the worker does not refuse all wage offers below the marginal product.⁸ This leads us to the two other equilibrium approaches.

The second approach to the determination of equilibrium wages is captured by the search-matching-bargaining equilibrium models of Mortensen (1982), Diamond and Maskin (1979), and Pissarides (1979, 1990). Here, the wage is the outcome of a decentralized bargaining game between the two parties involved in a match. According to the Nash Axiomatic solution to this bargaining game, a fixed fraction of the surplus of the match goes to the worker in the form of a wage. The strategic bargaining approach provide an equivalent framework (see Wolinsky, 1987).

Alternatively, the equilibrium is derived by assuming that the firms have all the bargaining power but they compete by posting wages prior to the moments at which applicants

⁷See Mortensen (1986)'s explicit reformulation of this approach within a search model with search on the job. Mortensen also discuss the limitation of this approach for the description of the equilibrium labor market. We will refer to all models where the wage offer distribution is given exogenously and is suppose to be equal to the marginal product of workers as "competitive equilibrium" models.

⁸This well known point was made by Diamond (1971) as a critique of the simple search model, with one reservation wage, where the firm can take the entire rent by offering to the worker his/her reservation wage.

are found (MacMinn, 1980, Burdett and Judd, 1982, Albrecht and Axell, 1984, Mortensen 1990, Burdett and Mortensen, 1998). Just like in the second approach, the wage is typically lower than the marginal productivity. Moreover, the wage (distribution) depends on the determinants of the behavior of all agents in the market. This equilibrium approach is called “posting equilibrium” where the surplus (depending on the information) is given to the firms.⁹

3 The Job Search Model

3.1 The Estimation of the Classical Job Search Model

Theory

Suppose that all workers are homogeneous ($x_i = 1$) and that there is a continuum of firms such that $p(z) = z$ and z has a c.d.f. $F(z), z \in (0, \infty)$. We assume that each firm is atomistic and in equilibrium offers a wage. Following Lucas and Prescott (1974), one may take this wage to equal the marginal product of labor, so that $w = z$.¹⁰ Furthermore, the offer arrival rate when the worker is unemployed is set by $\lambda_{ij}^u = \lambda > 0$, there are no offers while the individual is working, i.e., $\lambda_{ij}^e = 0$, and there are no layoffs and deaths, that is, $\eta = \delta = 0$.¹¹ Search efforts are exogenous, and therefore the utility in the unemployment state is given by $u_{it}^u = b$. Hence, if an unemployed worker receives a wage offer and s/he accepts it, then s/he will work at that wage forever. Now the Bellman equation for the worker’s problem can be written as an optimal stopping rule for work, such that,

$$\rho V^u = b + \lambda \left\{ \int_0^{\infty} \max[0, V^e(w) - V^u] dF(w) \right\}, \quad (2)$$

where V^u is the maximum expected value of being unemployed and $V^e(w) = \int_0^{\infty} e^{-\rho t} w dt = \frac{w}{\rho}$ the value of accepting an offer w . This equation has the familiar structure of asset flow value equations (see e.g. Pissarides, 1990). The return of the asset V^u in a small interval around

⁹There are papers where the equilibrium combines some of the features of a “posting equilibrium” game and some features of a sequential bargaining game (Postel-Vinay and Robin, 2002).

¹⁰The assumption that $w = z$ is inconsequential throughout this section. Alternatively, one may interpret the model as a partial job search model, where the distribution of wages is a structural model determinant. Yet another interpretation is that z is the match value of a firm and a worker and w is equal to a fraction of the match value (see matching models below) that for simplicity is assumed to be one.

¹¹The extension to $\delta > 0$ and $\eta > 0$ is immediate.

t equals the sum of the instantaneous utility flow in this interval, and the expected excess value of finding a job in this interval. When an offer of w arrives at t then there are two options: (i) to reject it (excess value zero), and (ii) to accept it (excess value $w/\rho - V^u$). It is clear that the optimal policy is to choose option (ii) iff $w > \rho V^u$. Therefore, the optimal strategy of the worker is a reservation wage policy $w^* = \rho V^u = \rho V^e(w^*)$. Using this condition in the above equation provides us with,

$$w^* = b + \frac{\lambda}{\rho} \left\{ \int_{w^*}^{\infty} [w - w^*] dF(w) \right\}. \quad (3)$$

There exists a unique w^* that solves for the optimal reservation wage policy.

Empirical Implications and Estimation Using Duration Data

The unemployment duration distribution for the above model is fully characterized by the constant hazard rate at duration τ of unemployment, $h(\tau)$, which is given by,

$$h(\tau) = \Pr(d_\tau = 1 \mid d_{\tau-d\tau} = 0) = \lambda(1 - F(w^*)) = h. \quad (4)$$

The survivor function for τ periods of unemployment is equal to $\Pr(t > \tau) = e^{-h\tau}$, and the density of the unemployment duration τ is given by $g(\tau) = \lambda(1 - F(w^*))e^{-\lambda(1-F(w^*))\tau} = he^{-h\tau}$. The likelihood function of a sample of durations for I unemployed workers, $\{\tau_i, i = 1, \dots, I\}$, with no incomplete spells of unemployment,¹² is given by,

$$L(b, \lambda, \rho, F(w) \mid \tau_1, \tau_2, \dots, \tau_I) = \prod_{i=1}^I he^{-h\tau_i}. \quad (5)$$

Clearly, using only duration data, the only identified parameter is the hazard rate, h , and *none* of the structural parameters of the search model is identified (Flinn and Heckman, 1982). It should also be noted that if the data consist of complete spells, then the hazard rate h can be easily estimated using the sample duration mean, by invoking that $E(\tau) = \int \tau g(\tau) d\tau = 1/h$.

¹²If the data contains censored observations with duration τ_s then the likelihood of each of these observations is just the survival probability, $e^{-h\tau_s}$.

Heterogeneity

A common fact is that for a random sample of unemployed workers the Kaplan-Meier maximum likelihood non-parametric estimator of the hazard rate is decreasing.¹³ This observation is consistent with the standard stationary search model if we allow for unobserved heterogeneity in parameters of the model. The simplest way to show this is by assuming that there are two types of workers, type A and type B, who differ with respect to at least one parameter of the model. Now for each type there will be a different hazard rate. Suppose that $h_A > h_B$, then type A workers leave the unemployment pool on average faster than type B. The pooled hazard rate is the mixture of the two types and converges monotonically to h_B as the duration increases. Now the likelihood function of the same duration sample of I unemployed workers is a mixture of two duration density functions. The separate hazard rates h_A and h_B and the proportions of the two types are identified from the duration data. However, again, *none* of the structural model parameters is identified.

Earnings and Job Search

Suppose we also have data on the wages that are accepted by workers at the moment they leave unemployment. Specifically, suppose that for each individual who finds a job we observe τ_i and the accepted wage w_i . The joint probability for the observations is

$$\Pr(\tau_i, w_i) = g(\tau_i)f(w_i | w_i > w^*) = (1 - F(w^*))e^{-\lambda(1-F(w^*))\tau_i} \lambda \frac{f(w_i)}{(1 - F(w^*))}, \quad (6)$$

together with the restriction $w_i \geq w^*$, and with the first term canceling out with the denominator of the last term.

In labor studies, the wage distribution is traditionally described by Mincer's earnings function: $\ln w = x'\beta + \epsilon$, where x is a vector of human capital indicators of the worker and $\epsilon \sim N(0, \sigma^2)$ is a random error that is assumed to be independent of x . In the context of the search model above it is natural to take the distribution of w to represent the distribution F of wage offers, and to take $\epsilon = \ln z$, that is, the error term in the wage equation is due only to the firm heterogeneity.

For sake of illustration, let the sample consist of initially unemployed individuals with the same human capital characteristics such that $x'\beta = \mu$. The likelihood function conditional on a sample of unemployment durations and accepted wages for I workers, $\{\tau_i, w_i, i = 1, \dots, I\}$, is now given by

¹³Eckstein and Wolpin (1995) discussed the evidence regarding this fact. Yet, for certain data sets, the hypothesis that the hazard rate is constant may be accepted.

$$L(b, \lambda, \rho, \mu, \sigma \mid (\tau_1, w_1), \dots, (\tau_I, w_I)) = \prod_{i=1}^I e^{-\lambda(1-\Phi(\frac{\ln w_i - \mu}{\sigma}))\tau_i} \lambda \frac{1}{w_i} \phi\left(\frac{\ln w_i - \mu}{\sigma}\right), \quad (7)$$

again with the restriction $w_i \geq w^*$, with ϕ the density of the standard normal distribution and Φ its c.d.f..

Identification

The theoretical restriction that $\Pr(w_i < w^*) = 0$ implies that the likelihood is zero if a wage is observed below the reservation wage. In fact, “the minimum of accepted wages (or any fixed order statistic) is a consistent estimator of w^* ” (Flinn and Heckman, 1982). From the observations on accepted wages the parameters of $F(w)$ can be consistently estimated. This is because lognormal distributions are *recoverable*: they can be recovered from a truncated version. Of course, if we observe a random sample of offered wages then we are able to identify $F(w)$ non-parametrically.¹⁴

Identification of F enables us to identify the job offer arrival rate λ and the job offer acceptance probability $(1 - F(w^*))$ as the two components of the hazard h . This is a central issue in understanding, interpreting and analyzing unemployment data. It enables separation of the main two causes of unemployment, that is, job availability and job acceptance. Moreover, this specification consistently corrects for potential bias in estimating the wage distribution due to the endogeneity of job acceptance. These biases are important when one tries to estimate the mean wage offer for different individuals in order to learn about the return to education, the gains from experience, discrimination, etc..

Note that b and ρ cannot be separately identified. If a value for ρ is set exogenously, as is frequently done in applied micro studies, then b can be recovered using the estimated reservation wage and the reservation wage equation above. Alternatively, if b is assumed to equal the observed unemployment benefits level (zero utility of leisure), then ρ can be estimated (see e.g. Van den Berg, 1990).

The result that the minimum observed wage is a consistent estimator of the reservation wage puts high demands on the data. A single observation may have a strong effect on the estimated acceptance rate of wages. This ignores the possibility of measurement error in reported wages. In addition, there may be a large small sample bias. Schoonbroodt

¹⁴See e.g. Narendranathan and Nickell, 1985, and Van den Berg, 1990; this can also be achieved using data on numbers or arrival times of job offers in combination with data on durations and accepted wages, see e.g. Blau and Robins (1986). Also, it is useful to point out that equilibrium models imply that the wage offer distribution has zero mass at wages below the lowest reservation wage (see Section 6), which in case of homogeneous workers implies that $F(w^*) = 0$.

(2003) investigates this in detail by way of Monte Carlo simulations for the simple search model. MLE estimation with 500-1000 observations gives rise to a *large* upward small sample bias of the arrival rate and a small positive bias for the mean wage. The latter is the result of the fact that all observed wages are above the reservation wage and only accepted wages are observed. This causes the MLE to have a large upward bias for the offer arrival rate due to the non-linear relation between these two parameters in the likelihood function. Schoonbroodt (2003) shows that the bias in arrival rates and mean offered wage of moment estimators is much lower than that of MLE since the bias in one parameter does not transfer to a larger bias in the other parameters.¹⁵

Measurement errors in reported wages can be easily included (Wolpin, 1987) by assuming that $\ln w^o = \ln w + u$, where w^o is the observed wage and u is a multiplicative measurement error that is independent of the true wage w and is distributed $N(0, \sigma_u^2)$. The likelihood function for this case is the product of $\Pr(\tau_i, w_i^o)$ ($\neq \Pr(\tau_i, w_i)$) over all the observations.

Heterogeneity can be introduced by assuming that certain parameters are different across different types of workers, as we explained above. Then the reservation wage is individual specific. Observed heterogeneity can be included by specifying that $\mu_i = x_i^l \beta$ as well as making the value of b a function of individual specific observations including benefits. The framework is also easily extended to allow unemployed workers to maximize utility rather than income, taking into account that jobs differ in e.g. hours or non-wage characteristics (see e.g. Khandker, 1988, and many other studies).

Maximum likelihood estimation can be done fully structurally. For virtually any functional form of F , the reservation wage equation does not allow for an explicit solution, so it has to be solved numerically. The numerical solution is subsequently used as a determinant of the distribution of durations and wages. In sum, the reservation wage equation is solved numerically at each iteration and the likelihood is maximized numerically. Heterogeneity increases computation time, because one needs to solve the reservation wage equation for each type of individual.

Nonstationarity

The above model is stationary because the parameters do not vary over time, and, as a result, the individual hazard rates (h) are constant over time. However, the pool (or aggregate) hazard rate may be duration dependent due to heterogeneity of the hazard rate

¹⁵This result provides a good rationale for using moment estimators rather than MLE in case of the potential existence of small sample bias.

among individuals. An alternative and additional source for duration dependence of the hazard rate is that the environment (parameters) at the individual level is not stationary. This includes the important case where the individual policy parameters change as a function of the elapsed unemployment duration. For example, the amount of unemployment benefits depends on the elapsed duration, or there is a stigma effect on wage offers that depends on the duration of unemployment. Sooner or later these changes are recognized and used by the individual in determining the optimal strategy.

Suppose that the parameters are allowed to vary over the interval of time, $\tau = [0, T]$, in a deterministic way, and job searchers have perfect foresight in the sense that they correctly anticipate changes of these parameters (Van den Berg, 1990). By analogy to the previous subsection,

$$\rho V^u(\tau) = \frac{dV^u(\tau)}{d\tau} + b(\tau) + \lambda(\tau) \cdot E_{w|\tau} \max\{0, \frac{w}{\rho} - V^u(\tau)\} \quad (8)$$

Now, the reservation wage $w^*(\tau)$ depends on τ by way of $w^*(\tau) = \rho V^u(\tau)$. Obviously, the reservation wage solution is more complicated than in equation (3). Equation (4) for h still applies, but now all parameters may vary over time:

$$h(\tau) = \lambda(\tau)(1 - F(w^*(\tau), \tau)) \quad (9)$$

Finite Horizon. A special case of the above is a finite horizon search model. Assuming that there is no income after period T , at the horizon T , the reservation wage equals $w^*(T) = b$, since the option value of search is zero at T . If all structural parameters are constant then it is straightforward to show that the reservation wage is monotonically decreasing before T . That is, $w^*(\tau) > w^*(\tau + \Delta)$ for any $\Delta > 0$. This implies an increasing hazard rate.

It is straightforward to derive the likelihood function for a nonstationary model using the joint duration and wage data. The likelihood is the product of the joint probabilities of the sequence of available data per individual as in (7). With a hazard rate $h(\tau)$ as a function of unemployment duration τ , the likelihood contribution of a realized unemployment duration τ_i equals $h(\tau_i) \exp(-\int_0^{\tau_i} h(\tau) d\tau)$. Note that the likelihood function now includes the restrictions $w_i \geq w^*(\tau_i)$.

An important gain from using nonstationary models is that it is possible to solve a search model with an endogenous state space in addition to changing parameters. For example, one may allow for the mean wage and the offer rate to depend on work experience

and unemployment duration (see Wolpin, 1987, 1992). In some applications, the initial condition for the differential equation (8) is obtained by assuming that the value function at time $T + 1$, $V(T + 1)$, is some "ad-hoc" specific function of the state variables at time T .¹⁶

Estimating Reduced-Form Hazard Rate Models

Consider equation (9). It would obviously be useful for any empirical analysis of unemployment durations to be able to separate between the two factors at the right-hand side, i.e. to assess their relative magnitude for different types of individuals, as well as to assess the size of policy effects on them. However, descriptive empirical analyses of unemployment durations motivated by the search model often simply restrict attention to variation of h itself over time and across individuals with different x . A popular approach is to specify h as a multiplicative function of τ and x . This defines the Proportional Hazard (PH) model, which is an ad hoc descriptive specification for h . The Mixed Proportional Hazard model extends this by including a multiplicative unobserved heterogeneity term at the individual level (see Lancaster, 1990, and Van den Berg, 2001, for overviews). In obvious notation,

$$h = h_{\tau}(\tau) \cdot \exp(x' \beta) \cdot h_{unobserved}.$$

This empirical approach raises some issues. First, although the applications interpret the results in terms of a job search model, the latter in general does not lead to a "proportional" specification as in the MPH duration model (Van den Berg, 2001). According to (9) the hazard rate h at τ depends on all structural parameters in a heavily nonlinear fashion by way of the current reservation wage $w^*(\tau)$. Even if individuals do not anticipate future changes of the structural parameters, and even if the structural parameters are simple functions of τ and/or x , this leads to a non-proportional expression for h . Because the MPH model parameters are not structural parameters, a causal interpretation of the reduced-form estimates is problematic. For example, from the point of view of the theory, β is not a structural parameter, and a change in one explanatory variable leads to changes in the elements of β that correspond to the other explanatory variables.¹⁷ What is more, a reduced-form analysis cannot separate between the relative magnitudes of the job offer

¹⁶The parameters of this function are estimated but it is not necessarily the case that the estimated function is consistent with the lifetime optimal plan (see, for example, Gilleskie, 1998). In Van den Berg (1990), the initial condition follows from stationarity of the model after a certain point in time.

¹⁷To some extent this problem can be captured by allowing for interaction effects, but this may lead to unidentified model specifications. Multi-spell data may be useful in this respect. See Van den Berg (2001) for details.

arrival rate and the acceptance probability, or estimate the relative magnitude of the effects of the x variables on them.

A second problem of reduced-form analyses concerns the identification of the effects of explanatory variables. This is typically achieved by a comparison across individuals. However, differences in, say, the benefits level across individuals may reflect other differences across individuals, like differences in their past labor market history, and this may not be controlled for in a reduced-form analysis. It is therefore useful to look for exogenous variation in the benefits level, for example in a natural experiment (Meyer, 1990). A third problem concerns instability of parameter estimates of the MPH model. Although the model is identified, the estimates may be very sensitive to functional form assumptions regarding duration dependence and the unobserved heterogeneity distribution. Both the second and the third problem can be tackled if one has access to multi-spell data, which contain multiple unemployment spells for the same individual. In that case one can exploit variation within individuals to identify the effects of interest.

To sum, the PH and MPH models are simple statistical specifications for a descriptive analysis of duration data in terms of conditional hazard rates. Not much can be concluded regarding potential explanations for the dependence of the duration on exogenous variables and, obviously, it is hard to analyze counterfactual policies using the estimated model.

3.2 Structural Estimates of the Classical Job Search Model

Kiefer and Neumann (1979) were the first to empirically investigate implications of the above standard search model with constant reservation wages, using reduced form equations. Flinn and Heckman (1982) were the first to structurally estimate the model.¹⁸

Flinn and Heckman (1982) use a sample of 20-24 years old U.S. white high school graduate males that do not attend school. Unemployment and non-participation are viewed as one state and the individuals are followed since they left school. Using the standard model infinite horizon search model that is presented above with maximum likelihood with two specifications for the wage offer distribution and several other assumption, their main findings are: 1. The job offer arrival rate (λ) is between 0.13 to 0.20 per month, so that the probability of encountering one (no) offer in the next six months is 0.36 (0.30 to 0.45); 2. The job acceptance probability is between 0.60 to 0.92 depending on the wage offer distribution function since the reservation wage is estimated by the lowest observed wage. As a result, the estimated mean of the wage offer distribution is lower than the mean of observed accepted wages, and the variance of the observed accepted wages is lower than

¹⁸See however Yoon (1981) for structural estimation of a somewhat different job search model.

the estimated variance of the offered wages; 3. The model fits the aggregate unemployment rate for this demographic group in the population from CPS data very well; 4. The results are not robust to the functional form specification of the wage distribution function.

Blau (1991) estimates a model in which instantaneous utility is a weighted product of wage per-hour and number of hours, where both are independently sampled when a job offer arrives. Furthermore, Blau deviates from Flinn and Heckman assumption that the lowest observed wage is the estimator for the reservation wage, by adopting the measurement error assumption for wages and hours, in the spirit of Wolpin (1987). Blau uses a sample of 25-35 white high school graduate males that do not attend school and that experienced a spell of unemployment. The estimated weekly offer rate is 0.065 in the first week and 0.037 by the 25th week of search with acceptance rate close to one. The model with hours fits much better the data on duration and wages but the estimated mean weekly offered wage is higher than the observed accepted mean weekly wage, which is opposite to what we expect. This might be due to estimated rate of job rejection being close to zero.¹⁹

The early examples of structural empirical analyses of *nonstationary* models with anticipation are Wolpin (1987) and Van den Berg (1990). Wolpin (1987) uses a discrete time search model over finite horizon, and he allowed for the offer rate to go down with the duration of unemployment in order to fit the decreasing hazard observations. Wolpin used a sample of white males that graduated from high school in 1979 (NLSY79) to get their duration of non-employment to first job and the wage at this job. Furthermore, he set the finite horizon to 500 weeks and he introduced measurement error in wages to allow for observed wages to be below the estimated reservation wage. The estimated model fits the non-employment duration data well, due to the estimated decreasing offer probability in order to fit the observed decreasing hazard rate.²⁰ The results show that the OLS estimator of a log wage equation provides upward selection bias of the constant (conditional mean) as well as in the coefficients of AFQT (army related psychometric test) and father's schooling.²¹ Wolpin estimated that the offer rate is about one percent per week and acceptance rate is close to one. As a result, the main impact on unemployment duration is due to changes in the job arrival rates, and there is very small impact for changes in mean offered

¹⁹Among more recent applications that are of interest are the papers by Bloemen (1993) and Fougère, Pradel and Roger (1998) who estimate the classical job search model with endogenous search efforts. They focus on the impact of a public employment service on search intensity.

²⁰The finite horizon model implies a decreasing reservation wage, which may fit the data only if a decreasing offer probability or unobserved heterogeneity are also present, which were not part of the estimated model (see Heckman, 1981).

²¹As we explained above the search model provides a structural selection rule for jobs which corrects for potential bias in estimating the conditional mean wage using accepted wages only.

wages and cost of search. Furthermore, increasing the weekly job arrival rate from one to five percent reduces unemployment duration by 60%.

Van den Berg (1990) specified and estimated a continuous time search model where the unemployment benefit levels change for an interval of two years. Using a sample of Dutch unemployed men he estimated that the offer arrival time is between 4 to 6 percent and the acceptance rate increases from about 70-87 percent at first data of search to 83-95 percent after two years. The main findings are that changes in the benefit levels along the interval of two years and, in particular, the end period level, have a large impact on unemployment duration for low and middle level education groups. Because of anticipation, the benefit level after two years has a strong impact on the hazard rate of the short-term unemployed. These are important results that have not been emphasized enough in the literature.²²

The empirical work based on the structure of the simple search model is relatively small and tentative. What has been learned is that it is possible to identify the job arrival rate and the acceptance rate from duration and accepted wage data.²³ This model provides the basis for the analysis of active labor market policy reforms that aim at reducing unemployment and increasing participation in many OECD countries who simultaneously practice welfare programs. It is widely believed that the labor supply elasticity at the extensive margins is large. The simple search model provides a useful analytical framework for a quantitative analysis of this elasticity. The existing empirical research in this framework is promising but preliminary.²⁴

²²The unpublished paper by Engberg (1991) provides an innovative structural analysis of a nonstationary search model with unobserved heterogeneity.

²³Lancaster and Chesher (1983) use subjective responses on reservation wages and expected accepted wages to estimate certain elasticities in the classical search model. This method has been adopted by a range of other studies.

²⁴Ljungqvist and Sargent (1998) specify a search model for unemployed where search effort affect the job offer arrival rate, and the individual faces random death and skill promotion when working. The model's parameters are set to match several moments and other empirically relevant aspects of the economy. The focus is on transitional dynamics of the economy with and without large welfare transfers that reduce labor supply at the extensive margin. An economy with a generous welfare system displays unemployment hysteresis in case of turbulence, because displaced workers have a low search effort at a time when their skills deteriorate.

4 Search on the Job

4.1 Models and Empirical Implementation

Burdett (1978) has extended the classical search model by allowing employed workers to search further for better jobs after a job has been formed. The model setup is the same as for the classical search model above, with the exception that the job offer arrival rate when employed is positive. We denote this rate by λ^e , and the arrival rate in unemployment by λ^u . In the basic on-the-job search model, a job is characterized by its wage w which is taken to be constant within a job. For a working individual, the search environment is specified in exactly the same way as we did earlier for an unemployed individual. Assume the model to be stationary. The optimal strategy is constant during a job spell, and the expected present value of search $V^e(w)$ when following the optimal strategy in a job with wage w satisfies,

$$\rho V^e(w) = w + \lambda^e \mathbb{E}_{\tilde{w}} \max\{0, V^e(\tilde{w}) - V^e(w)\}, \quad (10)$$

where the expectation is taken with respect to the distribution F of wage offers \tilde{w} (note that this equation has the same intuitively appealing form as equation (3)). Clearly, the optimal strategy is such that one accepts a job if and only if the offered wage exceeds the current wage w , so it suffices to compare instantaneous income flows (i.e., the optimal strategy is “myopic”), and the reservation wage of the employed worker simply equals the current wage. Hence, the worker accepts a job if and only if $\tilde{w} > w$. For a given current wage w , the hazard of the job duration distribution (or exit rate out of the present job) equals $\theta = \lambda^e(1 - F(w))$. As a result, the duration of a job with a wage w has an exponential distribution with this parameter θ .

If, during employment, exogenous separations occur at a rate $\delta \in (0, 1)$, then this does not affect the optimal strategy when employed. The exit rate out of the present job then equals $\lambda^e(1 - F(w)) + \delta$. In general, the possibility of search on the job affects the option value of search when unemployed and the optimal strategy reservation wage become,

$$w^* = b + (\lambda^u - \lambda^e) \int_{w^*}^{\infty} \frac{1 - F(w)}{\rho + \delta + \lambda^e [1 - F(w)]} dw. \quad (11)$$

Note that if the job offer arrival rates are the same in unemployment and employment then $w^* = b$, and so $h = \lambda^u(1 - F(b))$. In this case the option value of search as unemployed is zero. This model was extended to include endogenous search efforts within the Lucas and Prescott (1974) equilibrium search model (Mortensen, 1986), like in the general framework of Section 2.

Estimating On-The-Job Search Models

The extension of the model to include search on the job and search efforts enable the theory to fully characterize the joint distribution of the observed labor market states: nonemployment (out-of-the-labor force and unemployment), and working in job j during the working cycle c ($j, c=1, 2, 3, \dots$). An individual "cycle" is defined by the transition from nonemployment to work and back to nonemployment which is equivalent to the unemployment spell in the simple model.²⁵ The theory provides the joint distribution for work history for each individual based on the observed states and transitions among these states jointly with the observed wages. The likelihood function is equal to this joint distribution.

The main difficulties are the potential events that the theory predicts have probability zero. As in the simple model, no wage can be observed below the reservation wage and all transitions from job to job should be jointly observed with wage rise. The case is that some workers shift jobs with a wage decline. The simplest way to deal with these issues is to follow the idea of measurement error in wages as we describe above, following Wolpin (1987).²⁶

The identification of on-the-job search models with data on unemployment, job durations and wages is not fundamentally different from the identification of the standard search model. In particular, to identify F from λ^u and λ^e , one needs recoverability of F or data on rejected offers or equilibrium conditions. Also, ρ and b cannot be jointly identified without additional information.

The model can be generalized to allow for nonstationarity (see e.g. Van den Berg, 2001, for details). The fact that the optimal strategy of employed workers (10) is myopic makes it relatively easy to nest the expression for the job-to-job transition rate into a PH specification. Thus, the relation between theoretical and reduced-form model specifications is simpler than in the case of the standard search model for unemployed workers. This is also true for the exit rate out of unemployment h if $\lambda^u = \lambda^e$. In both cases, the structure imposes clear restrictions and interpretations related to the variables that enter the hazard rate.

²⁵It is possible to distinguish between out-of-the-labor force and unemployment within the nonemployment state if search efforts are different at this state. Out of the labor force in the model is the case where the job offer rate from nonemployment is zero (or close to zero). To empirically use this prediction the data should equivalently separate the two nonemployment states.

²⁶Flinn (2002) provides an exact formulation for this likelihood function. We avoid writing it here in order to save on complex details that do not add new ideas. The issue of incomplete cycles (spells) can be dealt with in the same way as incomplete spells in the simple model.

Search or Labor Force Participation. Eckstein and Wolpin (1989c) analyze the distinction between labor supply theory that is based on the search model vs. the labor supply theory that is based on period by period "new" wage and job draws, which they called "labor force participation model". The search model allows a worker to always stay at the existing job for the same wage as she received at the present period, unless she leaves to another job or quits. In a labor force participation model the worker cannot continue with the same job and wage period after period in certainty. In each period, the worker receives a new job offer as a random draw that is given by a probability that could be equal to one. If the worker receives an offer he draws the wage from a given distribution. The previous wage is then no longer available. Both the offer probabilities and the distribution of offered wages could change due to exogenous as well as endogenous state variables.

There is no aspect of the data that would force us to prefer one of the two models. The papers by Eckstein and Wolpin (1989b), Berkovec and Stern (1991) and Keane and Wolpin (1997), and more recent papers, prefer the labor force participation framework for empirically analyzing dynamic labor supply. The main reason is that since the wage is not part of the state space, the dynamic programming solution is easier to solve. However, conceptually the two models are observationally equivalent using data on employment, unemployment and the observed dynamic transitions among these states and the observed accepted wages.²⁷

4.2 Structural Estimates of On-the-Job Search Models

Flinn (2002) structurally estimated the above on-the-job search model to evaluate the welfare distributions in Italy and the US. Flinn (2002) used an Italian panel and a US (NLSY79) panel data of labor market history ("working cycles") for a sample of men to estimate, via maximum likelihood, the parameters of the model. The results show that the job arrival rates, λ^u and λ^e , the job destruction rate, δ , and standard deviation of offered wages are higher in the US than in Italy. Hence, the estimated search model is consistent with the observed facts that the earnings distribution is less equal in the US than in Italy both due to higher variability in the wage offer distribution and the higher mobility (flexibility) in the US labor market. The most striking result of Flinn (2002) is the model prediction that the present value lifetime inequality is much lower than the earnings inequality and, moreover, that the lifetime earnings inequality for the US is much *lower* than that of Italy. There is no other structurally estimated economic model that could

²⁷The finite horizon dynamic programming labor supply methods and applications are summarized in Eckstein and Wolpin (1989a), Eckstein and Wolpin (1989c), Keane and Wolpin (1994) and Wolpin (1995).

test directly the well known point made by Friedman (1962) that we have to distinguish between short and long run income inequality when we compare economies with different labor market mobility. Flinn (2002) is the first attempt to measure the potential sources and welfare implications related to the vast empirical literature on earnings inequality comparisons over time and countries (Katz and Autor, 1999).²⁸

Wolpin (1992) extends the search model of Wolpin (1987) to include the option of on-the-job-search in order to study the importance of work experience on wage offers for blacks and whites during the first five years after graduating from high school. The model is nonstationary due to the finite horizon and the assumption that the mean of the wage offer distribution and the on-the-job offer probabilities depend on experience and other endogenous work history variables. Wolpin (1992) uses quarterly data for the five years post schooling and the optimization over 40 years. Work history per individual is set by working cycles (see above description) and the parameters are estimated using the likelihood of the joint observation of the work history and wages for all high school graduate males in the panel (NLSY79), who did not go to college. Wolpin distinguishes between employer specific experience and general experience and finds that the sum of the two is higher for whites than for blacks. However, the blacks have higher offer rates of jobs while unemployed and employed. Since observed wages of blacks increase less than those of whites, work experience affects the lifetime earnings profile of people more than job offer arrivals in employment.

5 Search, Matching and Bargaining

5.1 Models and Empirical Implementation

An important extension of the simple search model above concerns the models where all workers and firms are ex-ante the same, but when a worker meets a firm they sample a value of the *match* between them (Diamond and Maskin, 1979, and Jovanovic, 1979). The value of this *match* is a random variable that represents the worker productivity, p_{ij} , such that $x_i = z_j = 1$, and it is sampled randomly from a given distribution function, $F(p)$, that is independent of worker and firm i and j . In addition it is usually assumed that there is no search on the job, so $\lambda^e = 0$. This extension leads towards an equilibrium specification that is more sophisticated than the Lucas and Prescott (1974) analysis of the search model.

²⁸Bloemen (1993) estimated a model with on-the-job-search and endogenous search efforts using simulated maximum likelihood. His focus was on the effect of exogenous variations in exogenous variables that affect the cost of search.

The conceptual equilibrium issue is how the match value is divided by the worker and the firm.

If the productivity of the match p is divided by a constant fraction (say, one half) then the model is equivalent to the simple search model described above (see Flinn and Heckman, 1982). Hence, we can interpret the simple search model as an equilibrium matching model where the wage rate w is a fixed fraction of the worker-firm random productivity (match) value.

In Diamond and Maskin (1979) and Mortensen (1982) it is assumed that firms and workers search for each other in a symmetric way, that is, firms solve a search problem that is equivalent to that solved by the unemployed worker.²⁹ In addition, it is assumed that the value of the match is divided by a Nash axiomatic bargaining equilibrium solution. Eckstein and Wolpin (1995) analyzed and estimated this model with endogenous search efforts, s , by workers and firms. The Nash axiomatic bargaining solution is characterized by a reservation match-productivity level p^* and a wage and profit functions that satisfy,

$$p^* = \rho V^{lu} + \rho V^{fu}; w(p) = \rho V^{lu} + \alpha(p - p^*) \text{ and } \pi(p) = \rho V^{fu} + (1 - \alpha)(p - p^*), \quad (12)$$

where V^{ju} is the expected present value of search of party j and $\alpha \in (0, 1)$ is the bargaining power of workers.

Eckstein and Wolpin (1995) show that the model is observationally equivalent to the search model if one uses the same data on durations of unemployment and accepted wages, without additional data on the firms and the market. The only difference is that the wage is a nonproportional function of productivity, and, hence, the equivalence to the simple search model is achieved only at a very special case where the firm and the worker have exactly the same optimization problem. In this case $\alpha = 0.5$ and the parameters related to the firm and the worker value functions are the same. It is natural to assume that this is not the standard economic case. In the general case, the likelihood function conditional on a sample of durations of unemployment and accepted wages for I workers, $\{\tau_i, w_i, i = 1, \dots, I\}$, is the product of $\Pr(\tau_i, w_i)$. The calculation of $\Pr(\tau_i, w_i)$ for evaluating the likelihood function can be done by numerical integration or using the method of simulated maximum likelihood (McFadden, 1989), by analogy to Subsection 3.1.³⁰

²⁹Wolinsky (1987) provides a very clear analysis of this model solved for equilibrium using the cooperative Nash axiomatic framework and the strategic Rubinstein's bargaining model.

³⁰Eckstein and Wolpin (1995) show that the identification of the bargaining power (α) and the search cost function using only data on unemployment durations and accepted wages is not robust, and if $F(p)$ is log-normal then $w(p)$ is not log-normal if $\rho V^{lu} + \alpha p^* \neq 0$, and one has to use numerical integration to

The Pissarides Model

The baseline Pissarides Model (see, e.g. Pissarides, 1990) differs in two ways from the above model. First, there is no match-specific heterogeneity. Secondly, the contact arrival rates are functions of the number of searching agents at both sides of the market, by way of a matching function, and the number of vacancies is endogenized by way of a free entry condition for firms. Due to the first aspect, there is only one equilibrium wage outcome. Clearly, this model is more amenable to macro-economic calibration analyses focusing on equilibrium effects of policy changes than to micro-econometric analyses focusing on heterogeneous outcomes at the individual level. However, whether we allow for match-specific heterogeneity (as described above) or not, the model if used in structural empirical analysis belongs to the same general framework of Section 2.

The model considers a labor market with a fixed continuum of workers. The (endogenous) measures of unemployed workers and vacancies are denoted by U and V . With fixed search intensities, the flow of contacts is given by the matching function $m(U, V)$, so that the job offer arrival rate λ equals $m(U, V)/U$. From the point of view of an employer with a vacancy, the arrival rate of workers equals $\lambda U/V$.

As in the previous model, in a given equilibrium, U and V are constant, so that the matching function has no empirical significance, unless one compares different equilibria. However, in case of policy changes, U and V may change. It turns out that policy effects and other equilibrium implications depend strongly on whether the matching function displays constant returns to scale or not. This has generated a vast literature in which matching functions are estimated. The matching function is identified by exploiting variation in U and V across different labor market equilibria.³¹

5.2 Structural Estimates of Search-Matching-Bargaining Models

Eckstein and Wolpin (1995) empirically estimate the return to schooling using post schooling duration to the first job and the accepted wage for that job. Schooling is assumed to be exogenous and divided into four levels: high school dropouts; high school graduates; some college, and college graduates. The return to schooling is defined in terms of the differences in mean *offered* wages between consecutive schooling levels, because the mean offered wage is an accurate indicator of the market value of productivity. The main point is that when labor supply is governed by the search-matching-bargaining model, the dif-

³¹Petrongolo and Pissarides (2001) survey the estimates of the matching function $m(U, V)$.

ferences in *observed accepted* wages are biased estimates for the return to schooling. It is assumed that the model is symmetric for workers and firms and allows for unobserved heterogeneity of five types (i.e. a discrete distribution with five points of support) for each schooling level. The main result is that the observed mean differences in accepted wages substantially underestimate the return to schooling using the NLSY79 data for blacks and white separately. It should be emphasized that theoretically the bias could be either way.³²

6 Equilibrium Search with Wage Posting

6.1 Background

Recently, a literature has emerged in which equilibrium search models are estimated (see Van den Berg, 1999, for a survey). In equilibrium search models, the wage offer distribution is endogenous. It results from optimal wage setting by firms that take account of the behavior of job seekers and other firms. The most important difference between these models and the search-matching-bargaining model and the simple search model above is that here a firm posts a wage prior to meeting a potential worker. The parameters of the endogenous wage distribution are fully determined by the productivity, search friction and preferences parameters. In Section 5, a firm and a worker determine the wage using a bargaining procedure over the surplus. In the Lucas and Prescott (1974) simple search model the wage dispersion is fully determined by the heterogeneity of productivity across firms and the workers' human capital, but there is no non-trivial effect of the amount of search frictions on the wage offer distribution. In all cases, the productivity distribution is determined exogenously, the worker job acceptance strategy determines the lower observed wage for each "type" of worker, and the equilibrium determines the truncation and location of the wage distribution relative to the productivity distribution,

Diamond (1971) made the point that if homogeneous firms (retailers) and workers (consumers) maximize profit and lifetime income (utility), respectively, then the equilibrium (perfect information) offered wage (price) by firms (retailers) is the unique reservation wage (price) of workers (consumers). This claim generated much criticism on the simple search model, which led to the posting equilibrium search analysis. It turned out that under limited information the equilibrium wage in the search model is consistent with wage

³²Flinn (2003) uses the search-matching-bargaining model to show how the minimum wage affect the entire accepted wage distribution by affecting the bargaining position of firms and workers. He uses CPS data to assess the welfare impact of the 1997 change in the US minimum wage but does not fully use the observed durations and accepted wages to estimate the model with maximum likelihood.

dispersion. In general, equilibrium wage offers are equal to the reservation wage of some (group of) worker(s). Thus, a model in which potential workers at a firm differ in their reservation wage values may generate wage dispersion. The underlying reason for the latter is that there is a trade-off between the profits per worker and the steady-state number of workers at the firm. In equilibrium, some firms may choose to set a high wage (giving a large workforce but small profits per worker) while others may prefer to set a low wage (giving a small workforce but high profits per worker). In general, the equilibrium wage (offer) distribution depends on all the parameters of the model including the search frictions in the form of the job arrival rates (λ^u and λ^e) and the distributions of worker and firm heterogeneity.

Basically, two approaches leading to equilibrium wage dispersion can be distinguished in the theoretical literature, depending on the source of the reservation wage heterogeneity. In the first approach (Albrecht and Axell, 1984, Eckstein and Wolpin, 1990), workers are heterogeneous in their opportunity cost of employment b . This implies heterogeneity of the unemployed workers' reservation wages using the same reservation wage strategy as we described above. In the second approach (Mortensen, 1990, Burdett and Mortensen, 1998), *ex ante* identical workers are allowed to search on the job. As we will explain below, this generates *ex post* heterogeneity of reservation wages across currently employed workers.

The equilibrium search models provide a framework to empirically analyze the sources of wage dispersion: a) workers heterogeneity (observed and unobserved); b) firm productivity heterogeneity (observed and unobserved); c) market frictions. The equilibrium framework can combine together the simple search on-the-job model, the search-matching-bargaining and the posting equilibrium models to empirically measure the quantitative importance of each source for the observed earnings and welfare dispersion as well as employment, unemployment and labor market mobility. The papers that we describe below illustrate what has been done and what could be learned further from this approach.

6.2 Models

For expositional reasons we start with the basic Burdett and Mortensen (1998) model, even though the theoretical and first empirical analyses of the Albrecht and Axell (1984) model predate the analyses with this model. The model considers a labor market consisting of fixed continuum of homogeneous workers (so, in the framework of Section 2, $I = 1$) and homogeneous firms. The measure of workers is denoted by m , and the endogenous measure of unemployed workers by u . The measure of firms is normalized to one. The supply side of the model is equivalent to the classic search model with on-the-job search. As a result, the

workers' optimal strategy is as in Subsection 4.1, and the unemployed workers' reservation wage is given by equation (11).

The construction of the equilibrium model starts with the equilibrium flows of workers for the posting wage model. It should be noted that these conditions could be imposed on all the models above and provide additional restrictions that could be used for identification of model quantities. Next, we describe the firms' strategy and construct the equilibrium.

Equilibrium flows of workers. Firms do not offer a wage below w^* , so that all wage offers will be acceptable for the unemployed.³³ Consequently, the flow from unemployment to employment is $\lambda^u u$. The flow from employment to unemployment is $\delta(m-u)$. In a steady state these flows are equal and the resulting rate u/m of unemployed workers equals

$$\frac{u}{m} = \frac{\delta}{\delta + \lambda^u}. \quad (13)$$

Let G be the "accepted earnings" distribution of wages paid to a cross-section of employees. These wages are on average higher than the wages offered, because of the flow of employees to higher paying jobs. The stock of employees with a wage less than or equal to w has measure $G(w)(m-u)$. The flow into this stock consists of unemployed who accept a wage less than or equal to w , and this flow is equal to $\lambda^u F(w)u$. The flow out of this stock consists of those who become unemployed, $\delta G(w)(m-u)$ and those who receive a job offer that exceeds w , $\lambda^e(1-F(w))G(w)(m-u)$. In the steady state, the flows into and out of the stock are equal, so

$$G(w) = \frac{\delta F(w)}{\delta + \lambda^e(1-F(w))} \quad (14)$$

where we have substituted for u using equation (13). Equations (13) and (14) are equilibrium flow conditions.

Firms' behavior. Firms post wage offers and they do not bargain over the wage. We assume that the wage and the marginal value product p do not depend on the identity of the employees or the number of employees. In the context of the framework of Section 2, p is a fixed constant model parameter while w and the steady state labor force of a firm l only depend on an index j denoting the firm. For convenience we omit the index j . A firm

³³This simple point made by Eckstein and Wolpin (1990) is relevant for the literature on non-parametric identification of the wage offer distribution where certain wages are not observed due to endogenous selection of jobs by workers. In the homogeneous equilibrium, wages that no one will accept will not be offered.

chooses w by maximizing the steady-state profit flow $(p - w)l(w)$ over w . In equilibrium, the firm sets w below p because it can always attain a positive profit by setting $w = w^*$. At a wage $w < p$ it is profitable to expand, so all firms always have a vacancy. As a result, the distribution of wages across firms equals the wage offer distribution.

Equilibrium. In equilibrium two conditions are met. First, the labor force of firms at each wage w should be equal to the effective labor supply at w , such that,

$$l(w)dF(w) = (m - u)dG(w),$$

which, by using (13) and (14),³⁴ gives

$$l(w) = \frac{m\delta\lambda^u(\delta + \lambda^e)}{\delta + \lambda^u} \frac{1}{(\delta + \lambda^e(1 - F(w)))^2}. \quad (15)$$

Second, since all firms are equal, the equilibrium steady-state profit flow must be equal for all equilibrium wages. Since the lowest wage in the market must be w^* , this condition amounts to

$$(p - w)l(w) = (p - w^*)l(w^*),$$

for all w in the support of F , which can be solved for F given w^* ,

$$F(w) = \frac{\delta + \lambda^e}{\lambda^e} \left(1 - \sqrt{\frac{p - w}{p - w^*}} \right) \quad (16)$$

Equations (16) and (11) for F and w^* constitute the Bayesian-Nash non-cooperative steady-state equilibrium. Firms always offer wages that are smaller than their productivity level, so they have a certain monopsony power. Because of wage dispersion, workers make job-to-job transitions, each firm faces prospective workers who are heterogeneous in their current minimum acceptable wage, and this in turn rationalizes the mixed strategy equilibrium that leads to wage dispersion. Since all workers and firms are identical, the presence of wage dispersion implies that the law of one price does not hold in equilibrium. The wage dispersion is fully due to the presence of search frictions with limited information.

Wage posting and bargaining equilibrium. To consider the similarities of the above equilibrium to the wage determination in the bargaining models of the previous section, we define the random variable y as

³⁴See Burdett and Mortensen (1998) for technicalities like the absence of mass points in F .

$$y = \frac{p - w}{p - w^*}, \quad (17)$$

with w the wage in a cross section of workers. It follows from the above equations that the density of y is

$$g_y(y) = \frac{\psi}{2(1 - \psi)} y^{-\frac{3}{2}}, \text{ for } \psi^2 \leq y \leq 1$$

with $\psi = \delta/(\delta + \lambda^e)$. Here $y = 1$ corresponds to the bottom and $y = \psi^2$ to the top of the job ladder. The distribution of the random position on the ladder y only depends on λ^e/δ , the expected number of job offers during an employment spell, and this is clearly a measure of the speed at which employees climb the ladder. If we rewrite equation (17) as

$$w - w^* = (1 - y)(p - w^*),$$

we see that in equilibrium the value of the match $p - w^*$ is split between the worker and the firm with $1 - y$ being the worker share, similar to equation (12). The latter is a random variable with a distribution that depends on the speed at which alternative offers are obtained. This analysis³⁵ clearly shows the similarity between wage determination in the wage posting equilibrium search model and wage determination in the bargaining models of the previous section: the surplus of the match is divided in accordance to the relative market power of the agents.

Note also that the mean of the relative mark-up y satisfies $E(y) = \psi = 1/(1 + \lambda^e/\delta)$. Hence, it follows that ψ or/and λ^e/δ are sensible measures of the labor market frictions, as they capture the extent to which firms are able to exploit such frictions when they set wages.³⁶

The main shortcomings of the model are that it predicts an increasing density of the cross-sectional wage distribution G and that it predicts a constant exit rate out of unemployment h (since $h = \lambda^u$). These implications are not consistent with almost all data sets. This has led to a series of papers that make both theoretical and empirical contributions by way of developing and estimating extensions of the basic model. To overcome the first shortcoming, the authors allowed firms in the model to be heterogeneous with respect to p . In general, the equilibrium solution for a market with heterogeneous agents differs from the solution for the homogeneous model. Bontemps, Robin, and Van den Berg (2000) provide a comprehensive analysis of the model with a general continuous distribution for p .

³⁵Borrowed from Van den Berg and Ridder (1998).

³⁶Ridder and Van den Berg (2003) work this out in a cross-country comparative empirical analysis. Mortensen (2003) and Van den Berg and Van Vuuren (2003) also use λ^e/δ to quantify search frictions.

Interestingly, the set of G that can be generated by varying the productivity distribution in the model over all possible continuous distributions can be characterized by the restriction that the wage density does not increase as fast as in the basic Burdett and Mortensen (1998) model. This is obviously good news from an empirical point of view.

The second shortcoming of the basic Burdett and Mortensen (1998) model (a constant exit rate out of unemployment) can be dealt with by allowing for heterogeneity across individuals of determinants of the exit rate (see Section 3). An example for this is the heterogeneity in the value of leisure, b , as in Albrecht and Axell (1984). Their model imposes that $\lambda^e = 0$ and that individuals are heterogeneous by nature with respect to their value of b . It should be stressed that b is assumed to be a time-invariant individual-specific characteristic. This excludes dependence of the individual's b on past wages. As we have seen, heterogeneity in b may generate equilibrium wage dispersion. Each point of support of F equals a reservation wage of an unemployed worker type. The distributions F and G are again different from each other, but now this is not because of job-to-job transitions but because unemployed individuals with high b only flow to jobs with high wages.

Clearly, the Albrecht and Axell (1984) model does not allow for job-to-job transitions. However, contrary to the basic Burdett and Mortensen (1998) model, the model allows for equilibria in which at least some unemployed workers reject at least some of their job offers some of the time. Moreover, changes in the unemployment benefits level may affect the unemployment duration distribution. Due to the heterogeneity in the unemployed workers' values of b , the aggregate unemployment duration distribution displays negative duration dependence.

The above models have been merged and extended. Mortensen (1990) extends the basic Burdett and Mortensen (1998) model by allowing both b and p to be heterogeneous. Postel-Vinay and Robin (2002) assume that workers and firms are heterogeneous in productivity and that workers are heterogeneous in their leisure preferences. They let workers to search on-the-job but deviate from the Burdett and Mortensen (1998) by assuming that when a worker and a firm form a match they immediately know their respective productivity and the output due to the match (as in the search-matching-bargaining model). Given their assumption the equilibrium has the property that the unemployed workers get their reservation wage (like in Diamond, 1971) but as the employed individual receives an outside offer, the two firms enter a Bertrand competition game. Clearly, wage determination shares some features of wage bargaining and some of wage posting.

In many ways, the Postel-Vinay and Robin (2002) model is richer than previous models. It allows for endogenous wage growth on the job and also for job-to-job transitions that result in a wage cut. It also allows identical workers to earn different wages at the same

firm. The authors show that the equilibrium accepted wage distribution has the well known Mincerian functional form, that is, $\ln w = \ln(\varepsilon) + (\text{search friction}, p)$, where ε is the index of worker's productivity and p is the firm productivity.

6.3 Structural Estimation

The basic Burdett and Mortensen (1998) model

Van den Berg and Ridder (1993b, 1998) and Kiefer and Neumann (1993) estimated the basic model before proceeding towards more complicated models. The model has four unknown parameters: $\lambda^u, \lambda^e, \delta$ and p . As in the simple search model, if b and/or ρ are unobserved then w^* constitutes a fifth unknown parameter. Observable durations, wages and exit destinations are all endogenous according to the model, and their distributions depend on the model parameters. Similar to the search on-the-job model, the wage data, if the job spells concern the first job after a spell of unemployment, then the corresponding wages are random drawings from the wage offer distribution F . If the job spells concern jobs occupied by a random sample of all workers who are employed at a certain point in time, then the wages are random drawings from G .

Consider a data set containing, for each respondent, an unemployment spell or a job spell with a wage, and the type of state occupied after the current spell. Mortensen (1990), Kiefer and Neumann (1993) and Van den Berg and Ridder (1993a) show that these data identify the parameters. Identification is most easily established by examining an estimation method that links the observables as directly as possible to the model primitives. Suppose one would estimate the model in two steps. In the first step, F is treated as an unknown distribution to be estimated nonparametrically (e.g. by way of kernel estimation) along with the arrival rate parameters. Further, w^* is estimated as the lowest observed wage. Clearly, the parameter λ^u is identified from the unemployment durations, and δ and λ^e are identified from the job durations ending in transitions to unemployment and to another job, respectively. In the second step, p is then identified by equating e.g. the mean of the theoretical F to the mean of the estimated F . In fact, the model is heavily overidentified with these data. For example, F is identified both from the wage sample and from the way in which the elasticity of the job-to-job transition rate with respect to the wage varies with the wage. Moreover, p is also identified from other moments of F . This reflects the ‘‘cross-equation restrictions’’ in the model: the parameters affect both the wage distributions and the duration distributions. In practice, this information is used to identify the heterogeneity distributions in richer model specifications (see below). The

unknown parameters are estimated simultaneously with Maximum Likelihood (ML)-type procedures.³⁷

The results in Van den Berg and Ridder (1993b) show that robust estimates can only be obtained if duration and wage data are jointly used.³⁸ Even so, we already know from the previous subsection that not too much should be expected from the fit of this model to labor market data. We now proceed by examining the estimation of generalizations of the basic Burdett and Mortensen (1998) model.

Estimation of models with heterogeneity; data on workers

Eckstein and Wolpin (1990) estimate the Albrecht and Axell (1984) model with heterogeneity both of firms' p and of workers' b . This was the first structural empirical analysis of an equilibrium search model. The first goal of Eckstein and Wolpin (1990) was to demonstrate the feasibility of estimating a Nash labor market equilibrium model using only data on workers. The second goal was to use the model to interpret the joint wage and duration distributions for workers who are supposed to be homogenous in their market productivity. The likelihood function, using the duration and the accepted wage data, has a similar form to that of the simple search model (7) but with (Heckman and Singer, 1984) unobserved heterogeneity. As noted, the model is rich in terms of explaining unemployment durations, and the estimated version fit the duration data well. However, the estimated unobserved heterogeneity of workers from the duration data had difficulty explaining the shape of the observed accepted wage distribution (Eckstein and Wolpin, 1990). This is due to the fact that each point of support of the wage offer distribution necessarily equals a reservation wage of an unemployed worker type. Allowing for heterogeneity in p across firms did not help here, and the measurement error accounted for almost all of the dispersion in observed wages.

Van den Berg and Ridder (1998) estimated an extended version of the Burdett and Mortensen (1998) model. They assume that the labor market is segmented and consists

³⁷Note that with ML, one has to take account of the fact that the support of F and G depends on the unknown parameters. This means that ML estimators have non-standard properties, like in the estimation of the classic search model of Section 3. The resulting estimates are obviously sensitive to outliers (i.e. measurement errors) in the wage data. One may deal with this by allowing for wage measurement errors in the empirical model specification (Van den Berg and Ridder, 1998). Also note that some job-to-job transitions result in a job with a lower wage. One may again allow for measurement errors in the wage data, or amend the model to allow for such transitions (Ridder and Van den Berg, 1997, Postel-Vinay and Robin, 2002).

³⁸This is also true for more general models; in fact, those may not even be identified from either data separately.

of a large number of separate different submarkets within which workers and employers are homogeneous. This means that observed market outcomes are statistical mixtures of market outcomes in the basic Burdett and Mortensen (1998) model. To distinguish the heterogeneity in the Van den Berg and Ridder (1998) model from heterogeneity within a given market, one may call the former “between-market” heterogeneity. It does not imply that a firm can only use one specific type of labor, provided that the firms’ production functions are additive in their different types of labor inputs. In this case p is a worker characteristic rather than a firm characteristic. This contrasts models with productivity heterogeneity “between markets” to models with productivity heterogeneity “within the market”, as in the latter case the productivity is a firm characteristic. In practice, segments can be defined by observed individual characteristics x like profession and level of education (e.g. each combination of profession and level of education defines a segment) as well as by unobserved characteristics. Allowing for between-market heterogeneity in p enriches the model by allowing for structural unemployment of workers whose p falls short of the wage floor (i.e., unemployment benefits or a mandatory minimum wage).

Suppose that segments are at least partly defined by unobserved characteristics. The distributions of the structural parameters across workers in different segments are then estimated along with any other model parameters. The likelihood is obtained by integrating (“mixing”) the likelihood associated with a homogeneous model with respect to the distributions of the parameters. Note that in this case the distributions of wage offers and wages among employed workers are mixtures of the corresponding distributions in the basic model. As may be expected, mixtures over the productivity parameter p provide an accurate fit to the wage data. The model also predicts negative duration dependence of the observed exit rate out of unemployment. Some individuals have a positive exit rate λ^u whereas the structurally unemployed have a zero exit rate, and this unobserved heterogeneity in the individual exit rate causes the observed exit rate to decrease as a function of duration.

Note that the distribution of p is not fully identified, as we only observe economic activity in segments where p exceeds the wage floor. This is a deep version of the non-recoverability problem in estimation of the classic job search model (see Section 3). Instead of the left-hand tail of the wage distribution it is now the left-hand tail of the productivity distribution that is not identified. It implies that the effect of a small increase in the wage floor is identified but the effect of a small decrease is not, unless one is prepared to make functional-form assumptions.³⁹

³⁹However, the *amount* of probability mass below the wage floor is now identified from the unemployment

The results indicate that job arrival rates are important determinants of the unemployment duration and the unemployment level and that job arrival rates for unemployed is only slightly higher than that for employed workers (about 0.04 per week).⁴⁰ The estimates are used to decompose wage variation into variation due to search frictions (i.e., the variation present in the homogeneous model) and the additional variation due to heterogeneity across segments. Typically the results indicate that at least 50% of wage variation is due to variation in productivity across segments, and at most 25% is due to search frictions. Hence, the main source for wage variation is due to productivity heterogeneity as it is in the simple search model and not to the non-competitive structure of the posting equilibrium structure of the model. Furthermore, they find that on average the wage mark-up is about 13% the competitive wage, and a policy experiment of increasing the minimum wage by 25% imply a 16% increase in unemployed workers.

Estimation of models with heterogeneity: data on workers and firms

Bontemps, Robin, and Van den Berg (2000) develop a model with a continuous distribution of within-market heterogeneity of p , and they develop and apply an estimation method that provides a nonparametric estimate of the productivity distribution.⁴¹ In the first step, the “transition” parameters λ^u, λ^e and δ are estimated along the lines of the identification argument in the above subsection.⁴² In the second step, the productivity distribution is estimated from the nonparametric wage data distribution, using the relationship between p and w that follows from the firms’ wage posting behavior in the model. Note that the estimates from the first step are only based on those parts of the model that describe worker behavior. The second step then exploits the first-order condition of the firms to estimate the productivity distribution. The estimates of the transition parameters can thus be expected to be consistent under a wide range of models of firm behavior and wage duration data, since it corresponds to the fraction of permanently unemployed individuals (this is exploited by e.g. Ridder and Van den Berg, 2003). This result neatly illustrates the interrelations between wage and duration variables in equilibrium search models, as well as the potential they offer for fruitful exploitation in empirical inference.

⁴⁰These estimates are lower than Blau (1989) estimates for the US. These findings are consistent with Flinn (2002) and the wide claim that the US labor market has more labor mobility than in Europe.

⁴¹One motivation for their work stems from their observation that if simple functional forms like a Pareto or lognormal distribution are adopted for p then this often does not give a good fit to the whole wage density. This is true even within segments based on occupation or industry. A Pareto distribution for p gives a better fit than (log)normal distributions or other popular distributions with a few parameters.

⁴²In fact, G is estimated nonparametrically from cross-sectional wage data, and this is used as input in the estimation of the transition parameters. Standard errors are obtained by bootstrapping.

determination. The estimation method provides a *perfect* fit to the wage data (if the model is correct). This estimation method has since been used by a number of other studies (see e.g. Mortensen, 2003) and serves as a starting point for the development of estimation methods for more complicated equilibrium search models.

Using the worker data, Bontemps, Robin, and Van den Berg (2000) find that the monthly arrival rates for the unemployed are about 0.07 and that the firms' wage mark-ups are large on average, in particular for the firms at the right tail of the distribution. Firm data are used to assess the qualitative and quantitative implications of the model and the estimates. For example, the firm data support the implication of the model that the wage and the profit share are increasing with productivity.⁴³

Postel-Vinay and Robin (2002) estimate their model using a French matched employee-employer panel data set on productivity, flows and wages. They use the estimated model to decompose the wage variance between the three potential sources: workers' personal heterogeneity, productivity heterogeneity, and market search frictions. A striking result is that workers' skill differences account for 50% of the wage variance in high-skill jobs, but for 0% in low-skill jobs. The market imperfection impact on the wage dispersion is typically 50% for all skills.

It seems obvious that the more complicated the equilibrium model, the more information is needed to estimate the size of the gap between a wage and its underlying productivity, but the literature shows that this view is an over-simplification. The Lucas and Prescott (1974) model, which is the starting point of the literature, equates wage and productivity, so that the gap is zero by assumption. Search-matching-bargaining models are more realistic in that they allow for a gap between wage and productivity. Specifically, they predict that the wage is a fraction of the productivity. However, we have seen that the bargaining parameter that determines this fraction is hard to identify from worker data only. The Burdett and Mortensen (1998) model and other wage posting models predict instead that the average gap between wage and productivity is primarily determined by the amount of frictions in the market, and the latter is identified from worker data. The Postel-Vinay and Robin (2002) model distinguishes between different productivity components, and both worker and firm data are required.

⁴³By now, dozens of studies have appeared in which similar models are estimated. Bontemps, Robin and Van den Berg (1999) estimate a model where both b and p have a continuous distribution. Mortensen (2003) is a detailed empirical study of the Burdett and Mortensen (1998) and Bontemps, Robin, and Van den Berg (2000) models, using Danish matched employee-employer panel data on flows and wages.

7 Concluding Comments

The empirical labor search models that are described in this survey provide a dynamic stochastic framework for the empirical analysis of most questions that labor economists consider. Furthermore, one can nowadays use cross section, worker panel, firm panel and matched employee-employer data to analyze equilibrium labor market models. These models can jointly consider labor supply issues related to unemployment, job mobility and wage dispersion as well as labor market discrimination and unemployment wage gaps (Eckstein and Wolpin, 1999, Bowlus and Eckstein, 2002). Furthermore, the models can be applied to the analysis of education policy and the return to education (see the review by Wolpin, 2003).

Is there any empirical evidence in favor of the posting/bargaining equilibrium search models vs. the simple Lucas and Prescott equilibrium interpretation? Until recently, the answer was: not really. The empirical research based on longitudinal labor supply data shows that productivity heterogeneity among firms is a useful assumption to fit the data. From such data, partial job search models are just identified under a functional form assumption on the wage offer distribution. Equilibrium search models provide a foundation for wage variation by way of a productivity distribution, so if the mapping between wages and productivities is identified then, by implication, longitudinal labor supply data also just identify the productivity distribution.⁴⁴ The Lucas and Prescott (1974) model, where the wage simply equals the productivity, can then be seen as a useful simple benchmark equilibrium search model with minimal assumptions.

Of course, the simple Lucas and Prescott equilibrium interpretation ignores the fact that firms often have an incentive to pay below productivity precisely because of search frictions. It certainly matters for many policies (like minimum wage policies and other policies that directly intervene in price formation) precisely how the relation between wages and productivities is in reality. Moreover, the reasoning in favor of the Lucas and Prescott (1974) model is based on longitudinal labor supply data. Firm or establishment level data and matched worker-firm data provide additional, over-identifying, information. Firm data may provide observations on productivities and wages. For example, Van den Berg and Van Vuuren (2003) combine Danish worker and firm data to examine the effect of frictions on the mean wage offered by firms in specific submarkets. It turns out that the effect is significantly negative. Wages are smaller than productivities, and the difference is larger if frictions are large. It should be pointed out that the quantitative effect of frictions on the sector-specific mean wage is small.

⁴⁴Recall however footnote 39.

What have we learned about the sources of wage dispersion? All empirical studies conclude that most wage variation is due to productivity variation. However, it would be too early to conclude from this that frictions are irrelevant for wage dispersion. First, many models predict that it is the interaction of frictions and productivity variation that explains wage dispersion. Productivity heterogeneity by itself cannot explain wage dispersion in the Burdett and Mortensen (1998) type of models, since in the absence of on-the-job search the degenerate Diamond (1971) wage solution applies. Secondly, reduced-form decompositions of wage variation typically assume that job-to-job mobility is not driven by the search for opportunities that are created by frictions.

What have we learned from the analysis of search models concerning the dynamic selection bias in the estimated return to education? It seems that the OLS estimated coefficients of the Mincerian equation might be upward biased and that much of the “return” to investment in education is hidden in the “black-box” of the market frictions. That is, in labor markets for high skilled workers there is less friction due to higher arrival rates of jobs.⁴⁵ Interpreting the OLS correlations in the Mincerian earnings equation is a great challenge to labor economists. Dynamic optimization theory in general, and search theory in particular, provide a natural interpretation framework for this goal, and much will be learned in future research.

The recent availability of the rich new data that match employees and employers requires a conceptual framework for the empirical analysis. At this point equilibrium search theory is probably the only theory that empirical economists can use for this purpose. The survey here tells the researchers how far this literature has reached so far.

⁴⁵It should be noted that the literature that focuses on using instruments to correct for selectivity/endogeneity bias in estimating the return to human capital investment, using the Mincerian function, ignore completely the labor market frictions that are discussed above (see Card, 2001).

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