



# The gender wage gap and the role of reservation wages: New evidence for unemployed workers<sup>☆</sup>



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## ABSTRACT

This paper examines the importance of differences in reservation wages for the gender wage gap. Based on two waves of rich survey data for a sample of newly unemployed individuals in Germany, we perform a decomposition analysis including measures for reservation wages, detailed information on education, socio-demographics, labor market history, as well as personality traits. In order to address the potential endogeneity of reservation wages we exploit a generated instrumental variable strategy that relies on heteroscedasticity of the error terms. Our findings indicate that the gender wage gap becomes small and statistically insignificant once we control for reservation wages. Moreover, we perform a subgroup analysis that provides valuable insights about the importance of potentially unobserved characteristics that affect reservation wages and realized wages simultaneously. Reasons for differences in reservation wages could arise from productivity differences, the fact that women anticipate discrimination and different unobserved traits or preferences.

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## 1. Introduction

The decomposition of gender and racial wage gaps can arguably be considered to be the Holy Grail in labor economics. In the case of the gender wage gap, despite numerous attempts by economists in the past, there typically still remains a sizeable unexplained gap (e.g. Altonji and Blank, 1999; Blau and Kahn, 2006). Early studies already identified the institutional wage structure (e.g. Blau and Kahn, 2003), gender differences in experience and tenure (e.g. Blau and Kahn, 1997), occupations (e.g. Grogan, 1991; Macpherson and Hirsch, 1995), qualifications (e.g. Blau and Kahn, 1997), college major (e.g. Brown and Corcoran, 1997; Machin and Puhani, 2003), promotion rates (e.g. Booth et al., 2003) and the penalty on women for having children (e.g. Waldfogel, 1997) as driving forces of the gender wage gap. In more recent years, new classes of explanations why women may choose alternative career paths have been proposed (see the discussion in Bertrand, 2010).

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These include gender differences in psychological attributes and risk preferences (e.g. Croson and Gneezy, 2009), attitudes towards competition (e.g. Lavy, 2012; Manning and Saidu, 2010) and negotiation (e.g. Babcock and Lascheyer, 2003), as well as differences in personality traits (e.g. Mueller and Plug, 2006). However, to date, most of these recent findings have been based on laboratory experiments and real world evidence is generally lacking. Therefore, more empirical evidence will be important in determining whether these explanations will have a lasting impact in the study of gender wage gaps (see Bertrand, 2010).

Closely related to the gender gap in realized wages, another strand of the literature provides explanations for gender differences in reservation wages. The reservation wage can be viewed as a measure of a person's eagerness or reluctance to accept employment and plays a key role in traditional job search theory (see Mortensen, 1986; Mortensen and Neumann, 1988) by determining the unemployment duration and the speed at which job-seekers will be reintegrated into the labor market (e.g. Rogerson et al., 2005). Gender differences in reservation wages might be related to different preferences for non-working time (e.g. Bowlus, 1997; Bowlus and Grogan, 2009), search frictions (e.g. Bowlus, 1997; Sulis, 2011; Kunze and Troske, 2012) and differences in productivity (e.g. Flabbi, 2010). Moreover, the wage gap can also emerge because heterogeneous firms can have different pay policies and offer different wages to men and women (e.g. Becker, 1971; Blackaby et al., 2005; Flabbi, 2010). Women could potentially anticipate such discriminatory behavior and hence adjust their reservation wages downwards to increase their future employment prospects. It is therefore possible that gender differences with respect to reservation wages might be simply a realization of anticipated discrimination against women in the labor market. Finally, differences in reservation wages could also express different preferences or personality traits, like the tendency for males to be overconfident (see Barber and Odean, 2001), the fact that women generally tend to be more risk averse (Eckel and Grossmann, 2008; Pannenberg, 2010) or women's preferences for occupations with higher social prestige (e.g. Kleinjans and Fullerton, 2013) and workplace flexibility (e.g. Goldin, 2014).

In this paper we combine these two strands of the literature in order to search for new explanations for the gender wage gap. We do so by examining the importance of gender differences in reservation wages in explaining the gender gap in realized wages for a sample of newly unemployed job applicants in Germany. The key research question we focus on is if any observed wage gap between men and women is simply an empirical realization of an initial gender gap in reservation wages. In particular, the novel contribution of the paper is including the reservation wage into the decomposition of the gender gap in realized wages. By having data on both reservation wages and realized wages on the same individual in a panel data set, we can determine the extent to which gender differences in aspirations and expectations regarding wages can be a self-fulfilling prophecy and lead to gender differences in actual wages. Although there has been previous work that attempts to decompose gender wage differentials that accounts for gender differences in reservation wages (e.g. Bowlus, 1997; Bowlus and Grogan, 2009), most studies do not have actual information on reservation wages and must infer them from observed outcomes in the data, such as the lowest observed wage. Previous empirical work involving reservation wages has generally been concerned with macro-labor issues such as unemployment insurance and unemployment rates (e.g. Feldstein and Poterba, 1984; Shimer and Werning, 2007). Others have been concerned with estimating the determinants of reservation wages, e.g., Brown et al. (2010) use the British Household Panel Survey (BHPS) data to examine the role of health in determining reservation wages and similarly, Prasad (2004) and Humpert and Pfeifer (2013) use data from the German Socio-Economic Panel (SOEP) to analyze the determinants of reservation wages of German workers.

Having access to panel data on reservation wages and realized wages for the same individual comes at the price that we can only draw conclusions for a specific sample of job-seekers entering unemployment shortly before they were interviewed for the first time but found a job within one year. Although this might raise concerns about the external validity of our results, it should be noted that this allows us to focus on a very homogeneous sample of unemployed job-seekers, which is probably the most relevant group when utilizing the concept of reservation wages. Nevertheless, it is possible that there are unobserved differences between men and women that influence reservation wages and realized wages simultaneously. For example, if women value job flexibility more than men, they may report a lower reservation wage and subsequently choose to accept a job with lower wages that allows for flexible hours. We conduct two types of sensitivity analysis – one based on an instrumental variable strategy, the other based on a subgroup analysis – indicating that potential endogeneity of reservation wages only has a minor impact on our decomposition results.

Previewing our main findings, we find as is typical in the literature that men earn more than women. Although, the inclusion of standard explanatory variables reduces the gender gap in realized wages somewhat, the gap still remains statistically significant. In this context, labor market histories appear to be an important driving factor of the gender wage gap, while socio-demographic characteristics, personality traits, search behavior and expectations have only a small impact. However, the striking result is that the inclusion of reservation wages halves the gender gap, making the remaining difference economically small and statistically insignificant. As the finding implies that reservation wages play an important role for the gender gap in realized wages, we also take a closer look at the determinants of reservation wages in an attempt to better understand how this initial gender gap in reservation wages arises. The rest of this paper is organized as follows. Section 2 describes the data in more detail and shows observed differences between men and women. Section 3 presents the decomposition of the realized gender wage gap and discusses the role of reservations wages, while Section 4 investigates potential explanations for gender differences in reservation wages. Finally, Section 5 concludes.

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